[JOINT COMMITTEE PRINT]

DESCRIPTION OF CERTAIN REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2015 BUDGET PROPOSAL

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation ("Joint Committee staff"), provides a description and analysis of certain revenue provisions modifying the Internal Revenue Code of 1986 (the "Code") that are included in the President's fiscal year 2015 budget proposal, as submitted to the Congress on March 4, 2014.[2] Because many of the provisions in the 2015 budget proposal are substantially similar or identical to those in the fiscal year 2014 and 2013 budget proposals, the Joint Committee staff has generally described only those provisions that did not appear in the fiscal year 2014 budget proposal or that are substantially modified from prior years' proposals.[3] The document generally follows the order of the proposals as included in the Department of the Treasury's explanation of the President's budget revenue proposals.[4] For new provisions, there is a description of present law and the proposal (including effective date), and a discussion of policy issues related to the proposal. For modified provisions, there is a description of the modification, and a footnote directing the reader to the Joint Committee staff's description of the revenue provision as it appeared in the fiscal year 2014 and/or 2013 budget proposal. For all other provisions, the text directs the reader to the Joint Committee staff's description of the revenue provision as it appeared in previous budget proposals.

As of December 15, 2014, H.R. 5771, the "Tax Increase Prevention Act of 2014," which extends for one year many provisions of the Code that expire for taxable years beginning after December 31, 2013 and some provisions that expire for taxable years beginning after December 31, 2014, has passed the House of Representatives and is scheduled for consideration by the Senate. Descriptions of present law that would be affected by the enactment of this legislation are denoted with a †.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014.

[2] See Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2014: Analytical Perspectives* (H. Doc. 113-84, Vol. III), March 4, 2014, pp. 141-187.

[3] The revenue provisions contained in the fiscal year 2013 budget proposal are described in their entirety in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012. Those provisions which were new or substantially modified in the fiscal year 2014 budget proposal are described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013.

[4] See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals*, March 2014.

PART I − ADJUSTMENTS TO THE BALANCED BUDGET AND EMERGENCY DEFICIT CONTROL ACT BASELINE

A. Permanently Extend Increased Refundability of the Child Tax Credit

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 751-753. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item I.1, reprinted in the back of this volume.

B. Permanently Extend the Earned Income Tax Credit for Larger Families and Married Couples

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 753-756. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Items I.2 and I.3, reprinted in the back of this volume.

C. Permanently Extend the American Opportunity Tax Credit

This proposal is substantially similar to a proposal found in last year's budget proposal. Last year's proposal was a modification of the prior year's proposal. That modification is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 2, and the original proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 34-39. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item I.4, reprinted in the back of this volume.

PART II − INCENTIVES FOR MANUFACTURING, RESEARCH, CLEAN ENERGY, AND INSOURCING AND CREATING JOBS

A. Provide Tax Incentives for Locating Jobs and Business Activity in the United States and Remove Tax Deductions for Shipping Jobs Overseas

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 73-82. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item II.A, reprinted in the back of this volume.

B. Enhance and Make Permanent the Research and Experimentation Tax Credit

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 97-116. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item II.B, reprinted in the back of this volume.

C. Extend and Modify Certain Employment Tax Credits, Including Incentives for Hiring Veterans[5]

Description of Modification

With respect to the work opportunity tax credit ("WOTC"), the fiscal year 2014 budget proposal is modified by expanding the definition of a qualified veteran. Under the 2015 proposal, in the case of individuals who begin work for the employer after December 31, 2014, a disabled veteran who uses G.I. Bill benefits to attend a qualified educational institution or training program within one year of being discharged or released from active duty, and who is hired within six months of ending attendance at such institution or program, would be a qualified

[5] This proposal makes changes to the work opportunity tax credit and the Indian employment tax credit. The work opportunity tax credit is described in Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 112th Congress* (JCS-2-13), February 2013, p. 151. The Indian employment credit is described in Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 112th Congress* (JCS-2-13), February 2013, p. 144. The modifications to these provisions which involve permanently extending these provisions as per the fiscal year 2014 budget proposal are described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 4. The estimated budgetary effect of the fiscal year 2015 budget proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), Items II.C.1 and II.C.2, reprinted in the back of this volume.

veteran for purposes of the WOTC. Qualified first year wages of up to $12,000 paid to such individuals would be eligible for the credit.

With respect to the Indian employment credit, the fiscal year 2013 budget proposal was modified by adjusting the calculation of the credit.[6] Under the 2015 proposal, for tax years beginning after December 31, 2014, the credit would be equal to 20 percent of the excess of qualified wages and health insurance costs paid or incurred by an employer in the current tax year over the amount of such wages and costs paid or incurred by the employer in the base year. The base year costs would equal the average of such wages and costs for the two tax years prior to the current tax year.

Analysis

Both the WOTC and Indian employment credit function as employer-side wage subsidies. In theory, such employment tax credits can reduce the costs of employing workers, increase demand for labor, and raise employment and wages. Two of the key issues in the design of wage credits are (1) whether they should be incremental and subsidize only those wage expenses that exceed a base level, and (2) whether they should be categorical and target the wages of particular groups of individuals, or non-categorical and apply to the wages of all groups of workers. While the WOTC is non-incremental and categorical, the Indian employment credit is incremental and categorical. These design features have implications for the economic effects of each credit.

Incremental vs. non-incremental credits

Wages credits are often implemented to encourage firms to increase employment and wages. When designing such credits, it is natural to consider how one determines whether the credits increased employment and wages. If the goal of a wage credit is to increase wages paid by the firm, for example, economists typically take this to mean that wages paid by the firm should be higher with the credit than they would be in the absence of the credit. As an administrative matter, measuring the wage expenses a firm would incur absent a credit is difficult--that outcome is not observed--which means that subsidizing only the portion of increases in wage expenses attributable to a wage credit is not feasible. One can avoid this measurement problem by designing a wage credit so that it applies to a company's entire wage bill. However, a credit structured in that manner will provide a tax benefit to employers who have neither increased employment nor wages, thereby generating a windfall since benefits accrue to taxpayers whose economic behavior has not changed.

Incremental credits, in contrast, limit such windfalls by subsidizing only the portion of wage increases above some base level. This feature makes incremental credits more cost-effective than non-incremental credits at raising employment and increasing wages. In

[6] The Indian employment credit calculation was first modified in the fiscal year 2014 budget proposal. This modification was not described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013.

particular, incremental credits help reduce windfalls to the extent that the base level accurately measures the amount of wage expense a firm would have incurred without the credit.

The WOTC is not an incremental credit and the overall WOTC benefits an employer receives does not depend directly on changes in the number of workers it hires from WOTC-targeted groups. For example, if an employer hires workers from WOTC-targeted groups in one year, releases them, and replaces them with the same (or fewer) workers from WOTC-targeted groups in another year, the employer can still receive a tax benefit even though there has been no increase (and possibly a decrease) in the number of workers it is employing from WOTC-targeted groups. Despite this feature, the overall number of workers a firm employs from WOTC-targeted groups may be higher than it would be without the credit, even if there are year-to-year changes in the number of employees from a WOTC-targeted group.

The Indian employment credit has the features of an incremental credit in the sense that it subsidizes only the portion of qualified wages and health insurance costs paid or incurred by an employer in excess of what was incurred in a base year. However, under present law the base year is 1993, which, as the Administration notes in its proposal, may be an inappropriate base year for purposes of an incremental credit. For example, if a firm employed no worker targeted by the Indian employment credit in 1993, then the credit provides a subsidy for all qualified employees employed by the firm in any subsequent year, even if there are no year-to-year changes in hiring. The Administration's proposal to change the base period to the two years prior to a taxpayer's current taxable year may make the Indian employment credit more targeted and cost-effective.

Categorical vs. non-categorical subsidies

The economics literature has generally shown that categorical wage subsidies such as the WOTC and Indian employment credit are less effective than non-categorical wage subsidies at increasing employment.[7] Some economists have attributed this result to possible stigma effects associated with being in a targeted group, since prospective employees must reveal that they are members of a targeted group in order for their employer to claim the wage credit. One study analyzed a wage credit for which welfare recipients were eligible, and found that job-seeking welfare recipients aware of their eligibility for the program, and provided with vouchers that employers could redeem for a direct cash subsidy upon hiring, were less likely to find employment than job-seeking welfare recipients who did not know they were eligible for the program and did not receive vouchers that revealed their status as welfare recipients.[8] The author hypothesized that the vouchers had a stigmatizing effect and helped employers screen out

[7] See the survey by David Neumark, "Spurring Job Creation in Response to Severe Recessions: Reconsidering Hiring Credits," *Journal of Policy Analysis and Management*, vol. 32, no. 1, pp. 142-171. The papers reviewed in the survey generally found that wage subsidies are ineffective, and whatever positive effects they have on employment tend to occur when the subsidy is combined with a job training component.

[8] Gary Burtless, "Are Targeted Wage Subsidies Harmful? Evidence from a Wage Voucher Experiment," *Industrial and Labor Relations Review*, vol. 39, no. 1, October 1985, pp. 105-114. In this study, welfare recipients were individuals who participated in Aid to Families with Dependent Children or received general assistance.

welfare recipients, who the employers were presumably reluctant to hire despite the cash subsidy.[9]

Even if a categorical wage subsidy does increase employment for a targeted group of workers, that does not necessarily mean that overall employment increases. It may cause firms to substitute non-targeted workers with targeted workers, thereby changing the composition of employment but not the level; non-targeted workers are employed at the expense of targeted workers. The potential job displacement effect of labor market policies targeting specific individuals has been documented in a number of studies. For example, one study of a French job placement assistance program for unemployed youths found that job gains by participants in the program came partly at the expense of other workers.[10] Non-categorical subsidies are more effective to the extent that they do not provide incentives for firms to hire one group of workers over another. In this respect, non-categorical subsidies are also more efficient because they do not discourage firms from hiring employees with the best qualifications. However, some may argue that categorical subsidies targeted at groups of workers who are on government assistance because they are unemployed may reduce costs for the Federal government. (Among the groups targeted by WOTC are individuals eligible for Temporary Aid to Needy Families and Supplemental Security Income.)

D. Modify and Permanently Extend the Renewable Electricity Production Tax Credit

Description of Modification†

The fiscal year 2015 budget proposal extends the present law renewable electricity production credit for facilities through 2014. For facilities the construction of which begins after December 31, 2014, the proposal permanently extends the credit and makes it refundable. The credit is also made available to otherwise eligible renewable electricity consumed directly by the producer, rather than sold to an unrelated third party, to the extent that the production can be independently verified. Solar facilities composed of property that currently qualifies for the energy investment tax credit are made eligible for the renewable electricity production tax credit in lieu of the investment tax credit through 2016. Solar facilities placed in service after 2016 are only eligible for the renewable electricity production tax credit. The permanent 10-percent investment credits for solar and geothermal property are repealed for property placed in service after December 31, 2016.

There are three principal modifications relative to the fiscal year 2014 budget proposal. First, the current proposal includes a one-year extension of present law (before any other modifications take effect). Second, the current proposal adds the exception to the third-party sale

[9] *Ibid*., p. 105.

[10] Bruno Crepon, Esther Duflo, Marc Gurgand, Roland Rathelot, Phillipe Zamora, "Do Labor Market Policies Have Displacement Effects? Evidence from a Clustered Randomized Experiment," *The Quarterly Journal of Economics*, vol. 128, no. 2, May 2013, pp. 531-580.

rule for independently verified producer consumed electricity. Finally, the current proposal repeals the 10-percent investment credits for solar and geothermal property.[11]

E. Modify and Permanently Extend the Deduction for Energy Efficient Commercial Building Property

Description of Modification†

The fiscal year 2014 budget proposal is modified by providing for a straight extension of present law deduction levels for property placed in service in 2014, and also updates the energy efficiency targets to reference the 2004 standards of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America ("ASHRAE/IESNA"), rather than the 2001 standards.[12] For property placed in service after 2014, the deduction levels increase to those proposed in the fiscal year 2014 budget proposal, and the update to the 2004 standards continues to apply. As provided for in the fiscal year 2014 budget proposal, the energy savings targets would be undated every three years by the Secretary of the Treasury in consultation with the Secretary of Energy.

The fiscal year 2014 budget proposal is also modified with respect to its application to existing buildings. The modification provides that existing buildings must meet the same 50 percent savings as new buildings, with no partial deductions allowed for buildings achieving savings between 20 and 50 percent. The modification provides the same deduction amounts as are provided for new buildings, rather than the greater amounts provided for in the fiscal year 2014 budget proposal. As provided for in the fiscal year 2014 budget proposal, the savings for existing buildings would be measured relative to a comparison energy-use baseline using methods and procedures provided by the Secretary of the Treasury in consultation with the Secretary of Energy.

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[11] The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 124-132, and is modified by the fiscal year 2014 budget proposal, described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 5. The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), Item II.D., reprinted in the back of this volume.

[12] The fiscal year 2014 budget proposal is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 6. The estimated budgetary effect of the current proposal can be found at Joint Committee on Taxation, Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal (JCX-36-14), April 15, 2014, Item II.E, reprinted in the back of this volume.

PART III − TAX RELIEF FOR SMALL BUSINESSES

A. Extend Increased Expensing for Small Businesses

This proposal is substantially similar to a proposal found in last year's budget proposal. Last year's proposal was a modification of the prior year's proposal. That modification is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 14, and the original proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 741-744. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item III.A, reprinted in the back of this volume.

B. Eliminate Capital Gains Taxation on Investments in Small Business Stock

Description of Modification

With respect to the proposal to eliminate capital gains taxation on investments in small business stock, the fiscal year 2014 budget proposal is modified by clarifying that small business stock can include stock acquired upon the exercise of warrants and options if the stock rights are acquired at original issue from the corporation, and that all relevant holding periods for the stock start on the date the stock is issued by the corporation to the taxpayer.[13]

C. Increase the Limitations for Deductible New Business Expenditures and Consolidate Provisions for Start-Up and Organizational Expenditures

Present Law

A taxpayer may elect to deduct up to $5,000 of start-up expenditures in the taxable year in which the active trade or business begins.[14] A corporation or a partnership may elect to deduct up to $5,000 of organizational expenditures in the taxable year in which the active trade or business begins.[15] However, in each case, the $5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up or organizational expenditures exceeds

[13] For a description of this proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 133-134. The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), Item III.B, reprinted in the back of this volume.

[14] Sec. 195(b)(1)(A).

[15] Secs. 248(a)(1) and 709(b)(1)(A).

$50,000.[16] Pursuant to such election, the remainder of such start-up expenditures and organizational expenditures may be amortized over a period of not less than 180 months, beginning with the month in which the trade or business begins.[17] A taxpayer is deemed to make an election to deduct and amortize start-up or organizational expenditures for the applicable taxable year, unless the taxpayer affirmatively elects to capitalize such amounts on a timely-filed (including extensions) Federal income tax return.[18] Capitalized amounts are recovered when the business is sold, exchanged, or otherwise disposed.[19]

Start-up expenditures are amounts that would have been deductible as trade or business expenses had they not been paid or incurred before business began.[20] Organizational expenditures are expenditures that are incident to the creation of a corporation or the organization of a partnership, are chargeable to capital, and that would be eligible for amortization had they been paid or incurred in connection with the organization of a corporation or partnership with a limited or ascertainable life.[21]

Description of Proposal

Under the proposal, the rules for start-up expenditures (section 195) and organizational expenditures (sections 248 and 709) are consolidated into a single provision for "new business expenditures."[22] A taxpayer may elect to deduct up to $20,000 of new business expenditures in the taxable year in which the active trade or business begins. The $20,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of new business expenditures exceeds $120,000. Pursuant to such election, the remainder of such new business expenditures may be amortized over a period of 180 months, beginning with the month in which the trade or business begins.

New business expenditures include amounts incurred in connection with (1) investigating the creation or acquisition of an active trade or business; (2) creating an active trade or business; (3) any activity engaged in for profit and for the production of income before the day on which

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[16] Secs. 195(b)(1)(A)(ii), 248(a)(1)(B) and 709(b)(1)(A)(ii). However, for taxable years beginning in 2010, the Small Business Jobs Act of 2010, Pub. L. No. 111-240, increased the amount of start-up expenditures a taxpayer could elect to deduct to $10,000, with a phase-out threshold of $60,000. Sec. 195(b)(3).

[17] Secs. 195(b)(1)(B), 248(a)(2) and 709(b)(1)(B).

[18] Treas. Reg. secs. 1.195-1(b), 1.248-1(c), 1.709-1(b)(2).

[19] Secs. 195(b)(2) and 709(b)(2). See also Treas. Reg. sec. 1.709-1(b)(3) and *Kingsford Co. v. Commissioner*, 41 T.C. 646 (1964).

[20] Sec. 195(c)(1).

[21] Secs. 248(b) and 709(b)(3).

[22] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), Item III.C., reprinted in the back of this volume.

the active trade or business begins, in anticipation of such activity becoming an active trade or business; and (4) expenditures that are incident to the creation of an entity taxed as a corporation or partnership, that are chargeable to a capital account, and that are of a character which (if expended incident to the creation of a corporation or partnership having a limited life) would be amortizable over such life.

Effective date.−The proposal is effective for taxable years ending on or after the date of enactment.

Analysis

Beginning in 2004,[23] an election to deduct up to $5,000[24] of start-up or organizational expenditures in the taxable year in which the active trade or business begins has been available to taxpayers. Congress's rationale for allowing a fixed amount of start-up or organizational costs to be deductible, rather than requiring their amortization, was to help encourage the formation of new businesses.[25]

To measure economic income accurately, cost recovery allowances should coincide with the period over which a taxpayer recoups the cost of its investment. Thus, accelerated cost recovery increases the economic return to initial investments in new businesses. The Administration's proposal lowers the after-tax cost of creating or organizing a new business by permitting the deduction of an amount up to $20,000 of new business expenditures rather than requiring those amounts to be capitalized and recovered either when the business is sold or through amortization deductions over 180 months.

By increasing the $5,000 deduction amount and the $50,000 phase-out threshold amount to $20,000 and $120,000, respectively, the proposal has the effects of generally permitting a larger deduction for businesses that qualify and permitting larger businesses to obtain the tax benefit of the deduction. Some may argue that this result is inconsistent with the policy goal of limiting the deduction to small businesses. On the other hand, it could be argued that there is no rationale for limiting the deduction to businesses below a particular size or with capital expenditures below a certain level if another goal of the proposal is to spur business creation or organization more generally.

For small firms, immediate expensing results in simplification, as those businesses that spend less than $20,000 are not required to capitalize and amortize such amounts. Advocates of the provision may take the position that allowing a taxpayer to elect to deduct a fixed amount in the year its active trade or business begins eliminates recordkeeping requirements with respect to

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[23] The American Jobs Creation Act of 2004, Pub. L. No. 108-357, sec. 902. Prior to 2004, taxpayers could elect to amortize start-up and organizational expenditures over a period of not less than 60 months.

[24] The relevant amount for start-up expenditures was increased to $10,000 for 2010. The Creating Small Business Jobs Act of 2010, Pub. L. No. 111-240, sec. 2031.

[25] See, *e.g.*, Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005, p. 504.

the new business expenditures and, thus, is more consistent with simplification of the tax law and administrative efficiency of the tax code. However, as long as some, but not all, of the taxpayer's new business expenditures are expensed, the taxpayer must still keep records for the remaining amount subject to capitalization and amortization.

An alternative argument can be made that the deduction and the phase-out amounts provided for in 2004 should be adjusted for inflation and that the increased amounts, in part, reflect the effect of inflation since 2004. If such amounts were adjusted for inflation, the amount eligible and phase-out amount under section 195 or sections 248 and 709 would be increased to roughly $6,200 and $62,000, respectively, for 2014.

D. Expand and Simplify the Tax Credit Provided to Qualified Small Employers for Non-Elective Contributions to Employee Health Insurance

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 138-145. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item III.D, reprinted in the back of this volume.

PART IV − INCENTIVES TO PROMOTE REGIONAL GROWTH

A. Modify and Permanently Extend the New Markets Tax Credit

This proposal is substantially similar to a proposal found in last year's budget proposal. Last year's proposal was a modification of the prior year's proposal. That modification is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 15, and the original proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 146-151. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item IV.A, reprinted in the back of this volume.

B. Restructure Assistance to New York City, Provide Tax Incentives for Transportation Infrastructure

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 178-179. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item IV.B, reprinted in the back of this volume.

C. Reform and Expand the Low-Income Housing Tax Credit

1. Allow States to convert private activity bond volume cap into low-income housing tax credits

Description of Modification

The fiscal year 2015 budget proposal modifies the prior year budget proposal[26] by (1) clarifying the applicable percentage that is used for the conversion ratio; (2) increasing the State-by-State limit on annual conversions from seven percent to eight percent of the private activity bond volume cap that the State receives for that year; and (3) providing alternative qualification by building owners for low-income housing tax credits associated with buildings financed with private activity bonds.

[26] The fiscal year 2014 budget proposal is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 18-20. The estimated budgetary effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item IV.C.1, reprinted in the back of this volume.

For each $1,000 of private activity volume cap surrendered, the State receives additional allocable low-income housing tax credits for the calendar year equal to $1,000 times twice the applicable percentage that applies for private-activity-bond-financed buildings under present law.[27]

Instead of obtaining 30-percent credits by financing at least 50 percent of the aggregate basis of a low-income housing project with qualified private activity bonds, the proposal allows a taxpayer to obtain 30-percent credits by satisfying two new criteria. The project must be allocated private activity volume cap in an amount not less than the amount of bonds that would be necessary to qualify for low-income housing tax credits under the 50-percent rule, and the volume cap allocation to the project must reduce the State's remaining volume cap as if the bonds had been issued.

Analysis of Modification

The alternative qualification aspect of the proposal allows projects to receive low-income housing credits without being financed by tax-exempt private activity bonds. Part of the rationale for a lower subsidy rate for projects that are financed with tax-exempt bonds is that the Federal government is already providing a subsidy to such projects through allowing a developer a lower cost of financing. That is, tax-exempt bonds typically carry a lower interest coupon than otherwise similar taxable bonds. However, there may be other costs associated with issuing qualified private activity bonds, including fixed costs of issuing such bonds. These may be sufficiently high such that a developer prefers to use taxable financing.

If a developer wishes to use taxable financing for a low-income housing project, the project competes for the limited supply of 70-percent credits. The proposal may increase the supply of credits for non-Federally subsidized projects, and at the 30-percent rate.

2. Encourage mixed income occupancy by allowing low-income housing tax credit-supported projects to elect a criterion employing a restriction on average income

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 186-188. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item IV.C.2, reprinted in the back of this volume.

3. Change formulas for 70 percent PV and 30 percent PV low-income housing tax credits

This proposal is substantially similar to a proposal found in last year's budget proposal. Last year's proposal was a modification of the prior year's proposal. That modification is

[27] This applicable percentage is unaffected by the subsequent budget proposal to change the formula for determining 70-percent and 30-percent allocated credits.

described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 21-22, and the original proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 195-197. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item IV.C.3, reprinted in the back of this volume.

4. Add preservation of Federally assisted affordable housing to allocation criteria

This proposal is substantially similar to a proposal found in last year's budget proposal. That proposal is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 22. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item IV.C.4, reprinted in the back of this volume.

5. Make the low-income housing tax credit beneficial to real estate investment trusts

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 188-195. The estimated budgetary effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item IV.C.5, reprinted in the back of this volume.

6. Implement requirement that low-income housing tax credit supported housing protect victims of domestic abuse

Present Law

In general

The low-income housing tax credit ("LIHTC") may be claimed over a 10-year period for the cost of building rental housing occupied by tenants having incomes below specified levels.[28] The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building. Eligible basis is generally adjusted basis at the close of the first taxable year of the credit period.

[28] Sec. 42.

Long-term commitment to low-income housing

No credit is allowed with respect to any building for the taxable year unless an extended low-income housing commitment is in effect as of the end of such taxable year. An extended low-income housing commitment is any agreement between the taxpayer and the housing credit agency that (1) (a) requires that the applicable fraction for the building for each taxable year in the extended use period not be less than the applicable fraction specified in such agreement and (b) prohibits the eviction or termination of tenancy (other than for good cause) of an existing tenant of any low-income unit, or any increase in the gross rent with respect to such unit not otherwise permitted; (2) allows individuals who meet the income limitation applicable to the building the right to enforce in any State court the requirement and prohibitions of (1); (3) prohibits the disposition to any person of any portion of the building to which such agreement applies unless all of the building to which such agreement applies is disposed of to such person; (4) prohibits the refusal to lease to a holder of a section 8 voucher because of the status of the prospective tenant as such a holder; (5) is binding on all successors of the taxpayer; and (6) is recorded pursuant to State law as a restrictive covenant with respect to such property.

Violence Against Women Reauthorization Act of 2013

The Violence Against Women Reauthorization Act of 2013[29] provides that an applicant for or tenant of housing assisted under a covered housing program may not be denied admission to, denied assistance under, terminated from participation in, or evicted from the housing on the basis that the applicant or tenant is or has been a victim of domestic violence, dating violence, sexual assault, or stalking, if the applicant or tenant otherwise qualifies for admission, assistance, participation, or occupancy. The low income housing tax credit program is a covered housing program for purposes of the Violence Against Women Reauthorization Act of 2013.

General public use requirement

To be eligible for the low-income housing credit, the residential units in a qualified low-income housing project must be available for use by the general public. A project is available for general public use if: (1) the project complies with housing nondiscrimination policies including those set forth in the Fair Housing Act (42 U.S.C. 3601), and (2) the project does not restrict occupancy based on membership in a social organization or employment by specific employers.[30] In addition, any residential unit that is part of a hospital, nursing home, sanitarium, lifecare facility, trailer park, or intermediate care facility for the mentally or physically handicapped is not available for use by the general public.

A project that otherwise meets the general public use requirements above does not fail to meet the general public use requirement solely because of occupancy restrictions or preferences that favor tenants: (1) with special needs; (2) who are members of specified group under a

[29] Pub. L. No. 113-4, sec. 601.

[30] See Treas. Reg. sec. 1.42-9.

Federal program or State program or policy that supports housing for such a specified group; or (3) who are involved in artistic and literary activities.

Description of Proposal

The proposal requires extended low-income housing commitments to provide protections for a victim of domestic violence, dating violence, sexual assault, or stalking (collectively, "domestic abuse").[31] An owner may not refuse to rent to a victim of domestic abuse. Under the Violence Against Women Reauthorization Act of 2013, being a victim of domestic abuse is not good cause for terminating a tenant's occupancy. Under the proposal, an owner may bifurcate the lease to treat a tenant or lawful occupant who engaged in criminal activity directly relating to domestic abuse differently from a tenant or lawful occupant who is a victim of that criminal activity. In the event that one tenant's occupancy is terminated due to criminal activity related to domestic abuse, the low-income status of the victim is not required to be tested as if the continuing occupant were a new tenant.

These protections are enforceable in any State court by any prospective, present, or former occupant of the building, whether or not that occupant meets the income limitations applicable to the building.

The proposal further provides that restrictions or preferences that favor victims of domestic abuse satisfy the "special needs" exception to the general public use requirement.

Effective Date

The proposal relating to extended low-income housing commitments is effective for extended low-income housing commitments that are either first executed, or subsequently modified, 30 days or more after the date of enactment.

The proposal related to the general public use requirement is effective for taxable years ending after the date of enactment.

Analysis

The proposal codifies a provision of the Violence Against Women Reauthorization Act of 2013 with respect to the low-income housing tax credit into the relevant provision of the Internal Revenue Code. While this largely represents a codification of present law, it provides some rules as to the enforcement of the protections for victims of domestic abuse.

The proposal relating to the general public use requirement is not expected to alter the utilization of low-income housing credits substantially.

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[31] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), Item IV.C.6, reprinted in the back of this volume.

PART V − REFORM U.S. INTERNATIONAL TAX SYSTEM

A. Defer Deduction of Interest Expense Related to Deferred Income of Foreign Subsidiaries

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 299-320. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item V.A, reprinted in the back of this volume.

B. Determine the Foreign Tax Credit on a Pooling Basis

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 321-332. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item V.B, reprinted in the back of this volume.

C. Tax Currently Excess Returns Associated with Transfers of Intangibles Offshore

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 333-353. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item V.C, reprinted in the back of this volume.

D. Limit Shifting of Income Through Intangible Property Transfers

Description of Modification

The fiscal year 2015 budget proposal modifies an earlier proposal first offered for fiscal year 2013 by stating that it "provides" rather than "clarifies" that the definition of intangible property for all purposes of sections 367 and 482 includes workforce in place, goodwill and going concern value. It also proposes replacing the phrase "any similar item," found in clause (vi) of section 936(h)(3)(B)(vi), with the phrase "any other item owned or controlled by a taxpayer that is not a tangible or financial asset." The modification further states that no inference is intended with respect to the scope of the definition of intangible property under present law. Finally, the modification clarifies that the proposed rule, under which the Commissioner may value the intangible properties on an aggregate basis where doing so

achieves a more reliable result, extends to transfers of intangible property in combination with other property or services as well as to transfers of multiple intangible properties.[32]

E. Disallow the Deduction for Excess Non-Taxed Reinsurance Premiums Paid to Affiliates

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 372-389. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item V.E, reprinted in the back of this volume.

F. Restrict Deductions for Excessive Interest of Members of Financial Reporting Groups

Present Law

A domestic corporation with a foreign parent may reduce the U.S. tax on the income derived from its U.S. operations through the payment of deductible amounts such as interest, rents, royalties, premiums, and management service fees to the foreign parent or other foreign affiliates that are not subject to U.S. tax on the receipt of such payments. Generating inappropriately large U.S. tax deductions in this manner is known as "earnings stripping." Although foreign corporations generally are subject to a gross-basis U.S. withholding tax at a flat 30-percent rate on the receipt of such payments if they are from sources within the United States, this tax may be reduced or eliminated under an applicable income tax treaty. The term "earnings stripping" applies more broadly to the generation of inappropriately large deductions for interest, rents, royalties, premiums, management fees, and similar types of payments in the circumstances described above. However, for purposes of the discussion of the Administration's proposal, the term "earnings stripping" will refer herein to the special case of the generation of excessive interest deductions.

Earnings stripping limitations

Present law limits the ability of foreign corporations to reduce the U.S. tax on the income derived from their U.S. operations through earnings stripping transactions. If the payor's debt-to-equity ratio exceeds 1.5 to 1 (a debt-to-equity ratio of 1.5 to 1 or less is considered a "safe harbor"), a deduction for "disqualified interest" paid or accrued by the payor in a taxable year is generally disallowed to the extent that the payor's "net interest expense" (*i.e.*, the excess of

[32] The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 354-371. The estimated budgetary effect of the current proposal can be found at Joint Committee on Taxation, Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal (JCX-36-14), April 15, 2014, Item V.D., reprinted in the back of this volume.

interest paid or accrued over interest income) exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion).[33] Disqualified interest includes interest paid or accrued to (1) related parties when no Federal income tax is imposed with respect to such interest,[34] or (2) unrelated parties in certain instances in which a related party guarantees the debt ("guaranteed debt"). Interest amounts disallowed under these rules can be carried forward indefinitely and are allowed as a deduction to the extent of excess limitation in a subsequent tax year. In addition, any excess limitation (*i.e.*, the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

Description of Proposal

The Administration's proposal limits the amount of U.S. interest expense that a member of a financial reporting group can deduct to the sum of the member's interest income plus its proportionate share of the financial reporting group's net interest expense computed under U.S. income tax principles. A financial reporting group is a group that prepares consolidated financial statements in accordance with U.S. Generally Accepted Accounting Principles ("GAAP"), International Financial Reporting Standards ("IFRS"), or other method authorized by the Secretary under regulations.[35] The proportionate share is determined based on the member's share of the financial reporting group's earnings (computed by adding back net interest expense, taxes, depreciation, and amortization) as reflected in the group's financial statements. However, if the member fails to substantiate its proportionate share of the group's net interest expense, the member's interest deduction is limited to 10 percent of its adjusted taxable income (as computed under section 163(j)). A member has the option of electing into this alternative treatment of its interest deduction limitation.

Disallowed interest under this proposal can be carried forward indefinitely and any excess limitation for a tax year can be carried forward to the three subsequent tax years.

U.S. subgroups are considered a single member of a financial reporting group under this proposal. A U.S. subgroup is defined as any U.S. entity that is not owned directly or indirectly by another U.S. entity, and all members (domestic or foreign) that are owned directly or indirectly by such entity; this rule effectively limits application of the proposal to foreign-controlled domestic corporations. If a U.S. member of a U.S. subgroup owns stock of one or more foreign corporations, this proposal applies before the Administration's proposal to defer

[33] Sec. 163(j).

[34] If a tax treaty reduces the rate of tax on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed under the treaty, bears to the rate of tax imposed without regard to the treaty. Sec. 163(j)(5)(B).

[35] The International Financial Reporting Standards are a set of accounting standards commonly used for the preparation of financial statements of public companies listed in countries outside the United States.

deduction of interest expense allocable to deferred foreign earnings.[36] Any interest expense incurred by the U.S. subgroup that remains currently deductible after application of this proposal is subject to deferral to the extent that the expense is allocable to deferred foreign earnings.

Financial services entities are exempt from this proposal, and they are excluded from financial reporting groups when applying this proposal to other members of the group. The proposal also exempts financial reporting groups that would otherwise report less than $5 million of net interest expense, in the aggregate, on one or more U.S. income tax returns for a taxable year. Taxpayers subject to this proposal are exempt from the application of section 163(j), but section 163(j) continues to apply to taxpayers exempt from this proposal.

The proposal grants the Secretary the authority to issue any Treasury regulations necessary to carry out the purposes of the proposal, including: (1) coordinating the application of the proposal with other interest deductibility rules; (2) defining financial services entities; (3) permitting financial reporting groups to compute the group's non-U.S. net interest expense without making certain adjustments required under U.S. income tax principles; and (4) providing for the treatment of pass-through entities. For financial reporting groups that do not prepare financial statements under U.S. GAAP or IFRS, it is expected that regulations would generally allow the use of financial statements prepared under other countries' generally accepted accounting principles in appropriate circumstances.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2014.

Analysis

Tax treatment of debt and equity

Corporations typically finance their operations through debt, equity, or a mix of both. While corporations can deduct the interest payments made to holders of theirs debt, they cannot deduct the dividend payments made to their equity investors. The differing tax treatment of debt relative to equity may encourage firms to borrow more than they would absent tax considerations. Some researchers have estimated that the value of the interest deduction can account for up to approximately nine percent of a firm's value, and that a number of firms can increase their value by borrowing more, although some studies have concluded that these estimates are overstated and that most firms have tax-efficient capital structures.[37]

Debt may be a tax-favored source of financing for corporations regardless of whether they have purely domestic operations or also operate overseas. However, for those corporations

[36] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals*, March 2014, pp. 42-43.

[37] For a discussion, see John Graham, "Do Taxes Affect Corporation Decisions? A Review," in G.M. Constantinides, Milton Harris, and Rene M. Stulz (eds.), *Handbook of the Economics of Finance*, vol. 2A, North-Holland Publishing Co., 2013, pp. 123-210.

that do operate overseas, debt may also serve as a channel for stripping earnings from high-tax jurisdictions to low-tax jurisdictions. This can be achieved, for example, if a foreign-controlled U.S. corporation borrows from a related foreign affiliate located in a low-tax jurisdiction. In this case, the interest expense incurred by the U.S. corporation may be deductible but the interest income received by the related foreign affiliate may be includible at a low tax rate. A similar result cannot be achieved by U.S.-controlled corporations, because the interest income received by controlled foreign corporations ("CFCs") is generally taxed as subpart F income, and because a loan to the U.S. parent corporation is generally considered an investment in U.S. property subject to inclusion under section 956. Therefore, even though both purely domestic corporations and multinational corporations may borrow more because interest expenses can be deducted, multinational corporations have an additional incentive to increase leverage if they can strip earnings from high-tax jurisdictions to low-tax jurisdictions through related-party borrowing. A number of empirical studies support the conclusion that multinationals are more leveraged in high-tax jurisdictions.[38] Studies have also found that internal borrowing is more sensitive to taxes than external borrowing, which is consistent with the hypothesis that multinational corporations can, and do, exercise greater latitude with borrowing in high-tax jurisdictions than purely domestic corporations.[39] However, these results do not separately identify overleveraging arising from (1) the differential tax treatment of debt relative to equity and (2) earnings stripping. One general prediction from the economics literature is that the leverage of a corporation increases as the tax rate it faces increases, since the value of interest deductions rises with the corporate tax rate. Therefore, even in the absence of earnings-stripping motives, a multinational corporation's optimal capital structure may involve higher leverage in high-tax jurisdictions than low-tax jurisdictions.

Implications for the Administration's proposal

The Administration's proposal aims to limit the extent to which foreign-parented multinationals can shift profits by disproportionately leveraging their U.S. affiliates. However, it is unclear how one determines whether a U.S. affiliate is overleveraged. Even if the U.S. affiliates of a foreign multinational corporation are more highly leveraged than their non-U.S. counterparts, it is not necessarily the case that this arises because of earnings stripping. As discussed above, it may be the case that a firm's optimal capital structure involves being more highly leveraged in high-tax jurisdictions than low-tax jurisdictions, absent the motive to strip earnings. Therefore, some may contend that the Administration's proposal does not properly distinguish leverage arising from the differential tax treatment of debt and equity from leverage that results from earnings stripping, which is the presumptive target of the Administration's proposal.

Interest expense deductibility is not limited under section 163(j) if the debt-to-equity ratio of a foreign corporation's U.S. affiliates is no greater than 1.5 to 1. Supporters of the

[38] For example, see Harry Huizinga, Luc Laeven, and Gaeten Nicodeme, "Capital Structure and International Debt Shifting," *Journal of Financial Economics*, vol. 88, no. 1., pp. 80-118.

[39] Mihir Desai, C. Fritz Foley, and James R. Hines, Jr., "A Multinational Perspective on Capital Structure Choice and Internal Capital Markets," *The Journal of Finance*, vol. 59, no. 6, pp. 2451-2487.

Administration's proposal may contend that it improves on section 163(j) by taking into account relative leverage and the inappropriateness of the safe harbor's uniformity across industries when the optimal capital structures of corporations differ widely by industry. For example, debt-to-equity ratios in the utility, chemical and transportation industries are significantly higher than debt ratios in the pharmaceutical industry.[40] Therefore, a company in a low-leverage industry may meet the safe harbor even if it is disproportionately leveraged, while a company in a high-leverage industry may not be able to meet the safe harbor even if it is disproportionately underleveraged. However, even if one agrees that these are flaws in section 163(j), it is unclear why financial services entities should be exempt from the Administration's proposal. A distinguishing feature of financial corporations in general is that a large part of their business involves borrowing and lending, which may make a leverage rule appropriate for non-financial corporations inappropriate for financial corporations because of the large gross flows of interest income and expenses in the financial services industry. However, the earnings stripping techniques available to nonfinancial corporations are available to financial corporations as well. Moreover, the Administration's proposal may already address some concerns specific to the financial services industry by basing a member's U.S. interest deduction partly on its proportionate share of the financial reporting group's earnings, therefore taking into account relative leverage in the same way that relative leverage is accounted for in non-financial industries. Under this view, an earnings stripping proposal applicable to both financial and non-financial corporations may be more appropriate.

Critics of the proposal may also argue that the Administration's proposal does not adequately measure leverage itself. The net interest expense incurred by a financial reporting group reflects borrowing levels more so than leverage: a corporation's leverage may be low, but borrowing levels may be high, if the corporation has a large amount of equity. Moreover, if foreign borrowing rates are higher than U.S. borrowing rates, the overall cost of foreign borrowing may be higher than the overall cost of U.S. borrowing even if the amount of debt incurred by U.S. affiliates is proportionate to that incurred by all other members of the financial reporting group. Therefore, the Administration's proposal may be more directly targeted at the consequences of borrowing on the U.S. tax base, rather than borrowing levels themselves. In addition, some may contend that because tax rules provide no clear line distinguishing debt from equity, formulas for interest expense deductibility based on balance sheet measures of leverage may not actually measure true leverage. However, the Administration's proposal potentially sidesteps this issue by not explicitly taking into account a corporation's balance sheet in computing limitations on interest expense deductibility.

Some may argue that determining interest expense limitations on the basis of a U.S. member's share of the financial reporting group's earnings may not be appropriate if (1) debt is generally incurred to support the purchase of assets and (2) the return on assets for a particular foreign-parented corporation is higher overseas than in the United States. If this is the case, then the U.S. member's interest expense limitation may be too low. However, it is unclear how one would determine whether this interest expense limitation is too low (or too high). A rule based

[40] See Stewart C. Myers, "Capital Structure," *Journal of Economic Perspectives*, vol. 15, no. 2, Spring 2001, pp. 81-102.

on a U.S. member's proportionate share of its financial reporting group's assets, rather than earnings, may be more appropriate under this view. However, some may point out that it is difficult to evaluate whether this proposal, section 163(j), or any other type of rule limiting interest expense, would result in a limitation that is too low or too high.

Book-tax differences

Although the Administration's proposal relies on U.S. income tax principles when calculating a financial reporting group's net interest expense, it uses financial statement information when determining the group's earnings. This may facilitate administration of the proposal because foreign-controlled groups may face difficulty in computing income under U.S. tax principles.[41] However, some may view this as a disadvantage of the proposal because financial accounting rules differ from tax accounting rules in ways that could influence the calculation of a U.S. member's interest expense deduction limitation. For example, dividends received by a corporation from stock in an unrelated corporation is included fully in income for financial accounting purposes, but may be eligible for a dividends received deduction for tax accounting purposes.

There are also differences between U.S. GAAP and IFRS that should be considered when evaluating the Administration's proposal. For example, IFRS does not allow for the use of the last-in, first-out ("LIFO") method of accounting for inventories,[42] while taxpayers are allowed to use LIFO under GAAP and the Code. To the extent that LIFO permits greater deductions for cost of goods sold when compared to an allowable inventory method under IFRS such as the first-in, first-out ("FIFO") method,[43] a financial reporting group's earnings may be lower under GAAP then IFRS.[44] Treasury may have authority to address this discrepancy under the rule-making authority granted by the Administration's proposal.

G. Modify Tax Rules for Dual Capacity Taxpayers

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 403-410. The estimated budgetary effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item V.G, reprinted in the back of this volume.

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[41] Furthermore, interest expense is determined under U.S. tax principles, but the proposal contemplates regulations that would simplify the process of calculating a non-U.S. member's net interest expense for this purpose.

[42] The LIFO method assumes that the items in ending inventory are those earliest acquired by the taxpayer.

[43] The FIFO method assumes that the items in ending inventory are those most recently acquired by the taxpayer.

[44] When costs are rising, the LIFO method results in a higher measure of costs of goods sold and, consequently, a lower measure of income when compared to the FIFO method.

H. Tax Gain from the Sale of a Partnership Interest on Look-Through Basis

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 411-416. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item V.H, reprinted in the back of this volume.

I. Prevent Use of Leveraged Distributions From Related Corporations to Avoid Dividend Treatment

Description of Modification

The fiscal year 2014 budget proposal is modified by including domestic corporations as either the funding or distributing corporation.[45] The 2014 proposal states that to the extent a foreign corporation (the "foreign funding corporation") funds a second, related foreign corporation (the "foreign distributing corporation") with a principal purpose of avoiding dividend treatment on distributions to a U.S. shareholder, the U.S. shareholder's basis in the stock of the foreign distributing corporation is not taken into account for the purpose of determining the treatment of the distribution under section 301. Under the fiscal year 2015 proposal, the rule applies to the extent a corporation (foreign or domestic) funds a second, related corporation (foreign or domestic).

J. Extend Section 338(h)(16) to Certain Asset Acquisitions

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 423-425. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item V.J, reprinted in the back of this volume.

[45] The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, p. 417. The fiscal year 2014 budget proposal is identical to the fiscal year 2013 budget proposal. The estimated budgetary effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item V.I, reprinted in the back of this volume.

K. Remove Foreign Taxes from a Section 902 Corporation's Foreign Tax Pool When Earnings Are Eliminated

Description of Modification

The fiscal year 2014 budget proposal is modified by addition of the statement that no inference is intended regarding the determination of the amount of foreign taxes deemed paid under current law.[46]

L. Create A New Category of Subpart F Income for Transactions Involving Digital Goods or Services

Present Law

General

The United States has a worldwide tax system under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad. A foreign tax credit, subject to certain limitations, is generally available to provide relief from double taxation of income earned abroad. Income earned in the United States and foreign income earned directly or through a pass through entity such as a partnership is generally taxed as the income is earned. By contrast, active foreign business earnings that a U.S. person derives indirectly through a foreign corporation generally are not subject to U.S. Federal income tax until such earnings are repatriated to the United States through a dividend distribution of those earnings to the U.S. person. Category-by-category rules apply to determine whether income has a U.S. source or a foreign source. Various tax regimes circumscribe the ability of U.S. persons to defer income by restricting or eliminating tax deferral with respect to certain categories of passive or highly mobile income. One of the main anti-deferral regimes is the controlled foreign corporation ("CFC") subpart F regime.[47] Additionally, the transfer pricing rules are designed to preserve the U.S. tax base.

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[46] For a description of this proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 426-431. This description included a question about the extent to which the proposal modified present law. *Ibid,* pp. 428-30. More recently, the Internal Revenue Service has issued guidance in which it concludes that when a foreign corporation's post-1986 undistributed earnings are reduced under section 312(a) in a section 302(a) redemption, a corresponding reduction of the foreign corporation's post-1986 foreign income taxes is required. See IRS Chief Counsel Generic Legal Advice Memorandum 2013-006 (Sept. 30, 2013). This conclusion is consistent with the view that the budget proposal represents present law.

The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), Item V.K, reprinted in the back of this volume.

[47] Secs. 951-956.

Sourcing rules

Rules for determining the source of certain types of income are specified in the Code. Various factors determine the source of income for U.S. tax purposes, including the status or nationality of the payor, the status or nationality of the recipient, the location of the recipient's activities that generate the income, and the situs of the assets that generate the income. In order to properly apply the sourcing rules to certain transactions, Treasury regulations include provisions addressing the classification of transactions involving computer programs.[48] These regulations generally require that transactions are treated as being solely within one of four categories, (1) a transfer of a copyright right in the computer program, (2) a transfer of a copy of the computer program (a copyrighted article), (3) the provision of services for the development or modification of the computer program, or (4) the provision of know-how relating to the computer programming techniques.[49]

A transfer of a computer program is treated as a transfer of a copyright right if, as a result of the transaction, a person acquires any of the following rights, (1) the right to make copies of the computer program for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease or lending, (2) the right to prepare derivative computer programs based upon the copyrighted computer program, (3) the right to make a public performance of the computer program, or (4) the right to publicly display the computer program.[50] A transfer of a computer program is treated as a transfer of a copyrighted article if the acquirer does not acquire any of the rights described above, and the transaction does not involve the provision of services or of know-how.[51] The determination of whether a transaction is treated as the provision of services is based on the facts and circumstances of the transaction.[52] The provision of information with respect to a computer program is treated as the provision of know-how only if the information is (1) information relating to computer programming techniques, (2) furnished under conditions preventing unauthorized disclosure specifically contracted for between the parties, and (3) considered property subject to trade secret protection.

Subpart F

Under the subpart F rules, a 10 percent-or-greater U.S. shareholder ("United States shareholder") of a CFC is subject to U.S. tax currently on its pro rata share of certain income earned by the CFC, whether or not such income is distributed to the shareholder. A CFC is defined generally as a foreign corporation with respect to which United States shareholders own more than 50 percent of the combined voting power or total value of the stock of the corporation.

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[48] Treas. Reg. sec. 1.861-18.

[49] Treas. Reg. sec. 1-861-18(b)(1).

[50] Treas. Reg. sec. 1.861-18(c)(1)(i).

[51] Treas. Reg. sec. 1.861-18(c)(1)(ii).

[52] Treas. Reg. sec. 1.861-18(d).

Income subject to current inclusion under subpart F includes foreign base company income.[53] Foreign base company income includes foreign personal holding company income,[54] foreign base company sales income,[55] and foreign base company services income.[56]

Foreign personal holding company income

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and real estate mortgage investment conduits ("REMICs"); (3) net gains from commodities transactions; (4) net gains from certain foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; (7) payments in lieu of dividends; and (8) amounts received under personal service contracts. There are several exceptions to the general rule of current taxation on foreign personal holding company income.[57]

Foreign base company sales income

Foreign base company sales income generally consists of income derived by a CFC in connection with: (1) the purchase of personal property from a related person and its sale to any person; (2) the sale of personal property to any person on behalf of a related person; (3) the purchase of personal property from any person and its sale to a related person; or (4) the purchase of personal property from any person on behalf of a related person. In each of the situations described in items (1) through (4), the property must be both manufactured outside the CFC's country of incorporation and sold for use outside of that same country for the income from its sale to be considered foreign base company sales income.[58] Certain exceptions to this general rule may apply. For example, income from sales of property involving a related person may be excluded under section 954(d) if the manufacturing exception applies.

Foreign base company services income

Foreign base company services income generally consists of income from services performed outside the CFC's country of incorporation for or on behalf of a related person,[59]

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[53] Sec. 952(a).

[54] Sec. 954(a)(1).

[55] Sec. 954(a)(2).

[56] Sec. 954(a)(3); see also sec. 954(a)(5) (foreign base company oil related income).

[57] For example, there is an exemption for rents and royalties derived in active business. Sec. 954(e)(2).

[58] Sec. 954(d)(1).

[59] Sec. 954(e).

including cases where substantial assistance contributing to the performance of services by a CFC has been furnished by a related person or persons.[60] Substantial assistance consists of assistance furnished (directly or indirectly) by a related U.S. person or persons to the CFC if the assistance satisfies an objective cost test. For purposes of the objective cost test, the term "assistance" includes, but is not limited to, direction, supervision, services, know-how, financial assistance (other than contributions to capital), and equipment, material, or supplies provided directly or indirectly by a related U.S. person to a CFC. The objective cost test is satisfied if the cost to the CFC of the assistance furnished by the related U.S. person or persons equals or exceeds 80 percent of the total cost to the CFC of performing the services.[61]

Pricing for transfers between related persons

Transfer-pricing rules, including the comprehensive regulations promulgated thereunder, are designed to preserve the U.S. tax base by ensuring that income properly attributable to the United States is not shifted to a foreign controlled party through inappropriate or aggressive pricing of related party transactions that does not reflect an arm's length result.[62] The Code specifies that income with respect to inter-company transfers or licenses of intangible property be commensurate with the income attributable to the intangible property. Under these rules, the IRS generally attempts to determine the respective amounts of profits of the related parties that would have resulted if the parties had been unrelated parties dealing at arm's length, and may allocate income, deductions, credits or allowances among related business entities when necessary to clearly reflect income or otherwise prevent tax avoidance. Most U.S. trading partners have adopted rules based on the arm's length standard.

Section 367(d) provides a related rule under which compensation, in the form of an imputed royalty stream, is required for an outbound transfer of intangible property in the context of an otherwise nontaxable corporate organization or reorganization transaction.

Description of Proposal

The proposal creates a new category of subpart F income, foreign base company digital income. Foreign base company digital income generally includes income of a CFC from the lease or sale of a digital copyrighted article or from the provision of a digital service. It includes income in cases where the CFC uses intangible property developed by a related party (including property developed pursuant to a cost sharing arrangement) to produce the income and the CFC does not, through its own employees, make a substantial contribution to the development of the property or services that give rise to the income. An exception applies where the CFC earns

[60] Treas. Reg. sec. 1.954-4(b)(1)(iv).

[61] Notice 2007-13, 2007-5 C.B. 410. Prior to the issuance of Notice 2007-13, the substantial assistance rules also included a subjective principal element test. Under the subjective principal element test, assistance in the form of direction, supervision, services or know-how were considered substantial if the assistance provided the CFC with skills which where were a principal element in producing the income from the performance of such services by the CFC.

[62] Whether the pricing is appropriate is measured by the arm's-length standard. Treas. Reg. sec. 1.482-1.

income directly from customers located in the CFC's country of incorporation that use or consume the digital copyrighted article or digital service in such country.[63]

Effective date.−The proposal applies to taxable years beginning after December 31, 2014.

Analysis

Taxing digital income

The Administration, the Organization for Economic Cooperation and Development ("OECD") and others recognize the inherent challenges in defining, sourcing, and taxing transactions in the digital economy.[64] In its recent action plan on base erosion and profit shifting ("BEPS"), the OECD recognized the digital economy as a specific concern and the action plan includes an action item for addressing the tax challenges of the digital economy.[65] The OECD notes that the digital economy's reliance on intangible assets, huge data sets, multi-sided business models,[66] and the difficulty of determining where value creation occurs "raises fundamental questions as to how enterprises in the digital economy add value and make their profits, and how the digital economy relates to the concepts of source and residence or the characterisation of income for tax purposes."[67]

The OECD in its action plan expressed particular concern with transactions that separate income from the activities that generate the income. The increasing reliance on digital means to provide goods and services may create unique opportunities to separate activity from income. Although features of the digital economy provide unique opportunities for BEPS, some may question whether there is a relevant distinction between the digital economy and other parts of the economy. The OECD acknowledges that the BEPS opportunities inherent in digital transactions are not easily addressed through arbitrary distinctions between the digital economy

[63] The estimated budgetary effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item V.L, reprinted in the back of this volume.

[64] The discussion of the tax challenges of the digital economy is not new. Academics and governments have been studying and writing on these challenges for many years. See, *e.g.*, David Tillinghast, "The Impact of the Internet on the Taxation of International Transactions," *Bulletin International Fiscal Documentation*, vol. 50, 1996, p.524; U.S. Department of the Treasury Office of Tax Policy, "Selected Tax Policy Implications of Global Electronic Commerce," 1996; and OECD Business Profits Technical Advisory Group, "Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce?," 2003.

[65] OECD, *Action Plan on Base Erosion and Profit Shifting*, 2013. Available at http://dx.doi.org/10.1787/9789264202719-en, ("OECD Action Plan").

[66] Multi-sided business models may include models where the users or consumers themselves add value, or where the data collected about users and consumers is valuable to the providers of the service or product.

[67] OECD Action Plan, p.10.

and the economy as a whole.[68] For this reason, the OECD may address the specific tax challenges posed by the increasing use of technology through other BEPS actions. In speaking about the OECD work on the digital economy, Robert Stack, Treasury deputy assistant secretary (international tax affairs) said, "We quickly concluded that the world is digital, the economy is digital, and you really can't hive off the digital economy from the rest of the economy as a basis for setting up some kind of fundamental new tax regime."[69]

The proposal does not attempt to separate the digital economy from the rest of the economy, but it does target digital transactions, specifically, transactions involving a CFC leasing or selling a digital copyrighted article or providing a digital service, where the CFC uses intangible property developed by a related party. The Administration may argue that this focus on specific digital transactions targets an appropriate type of transaction because of the crucial role of the intangible property and the inherent mobility of income produced from transactions involving non-physical goods and services. Others may argue that an increasingly digital economy may complicate efforts to segregate and tax income from digital goods and services where the economy is increasingly moving towards the digital platform. It may not be possible to effectively distinguish between a digital article or service and a non-digital article or service.

The Administration uses an example of a digital transaction involving the transfer (by sale or lease) of a copyrighted computer program or the provision of a digital service by hosting a computer program on a server. The characterization of these transactions is addressed in the sourcing regulations discussed in present law above. The Administration may use the sourcing regulations as a starting point to identify transactions that fit under the proposal as the regulations provide guidance regarding the characterization of certain transactions as either a transfer of a copyright right, a copyright article, the provision of services, or the provision of know-how. The examples provided by the Administration have the advantage of clearly fitting within the definition of the targeted transactions under the proposal and the taxpayer would need to determine whether the intangible property, the computer program in this case, was developed by a related party and whether the CFC made a substantial contribution to the development of the computer program. However, new technologies and transactions may not fit so neatly into these categories and the intangible property may not be so readily identified.

The role of subpart F

The subpart F rules are intended to require current U.S. taxation of certain passive and highly mobile income. The Administration believes that the existing categories of subpart F income do not adequately address mobile income earned from providing digital goods and services. Additionally, the Administration argues that the subpart F rules have not kept pace with advances in technology and a new category of subpart F income targeted at digital income is necessary to prevent erosion of the U.S. tax base.

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[68] OECD, *Addressing the Tax Challenges of the Digital Economy*, 2014. Available at http://dx.doi.org/10.1787/9789264218789-en (the "OECD Digital Economy Report").

[69] See, Marie Sapirie, "Stack Previews BEPS Digital Economy Report," *Tax Notes International*, August 4, 2014, p. 354.

By choosing different forms for substantially similar transactions involving digital goods and services (leases, sales, or services), taxpayers may be able to avoid the application of the existing subpart F rules. Proponents may argue that the current subpart F rules may enable a U.S. taxpayer to use CFCs to shift income related to digital goods and services to low-tax jurisdictions, in many cases eroding the U.S. tax base. The present law subpart F foreign base company sales and services income categories generally address physical goods or the physical performance of services. For example, the foreign base company sales income rules apply when there is a purchase of personal property from a related person and where the property is manufactured and sold for use outside of the CFC's country of incorporation. These rules may not apply where there is a sale of a digital good to an unrelated party. It may be difficult to assess the location of the "manufacture" or "sale" of a digital good, or to determine where a non-physical service is performed. The Administration provides an example of a CFC conducting business with remotely-located customers through the "cloud" using intangible property acquired from a related party, with the CFC not conducting any substantial business activities of its own. The CFC may have sales or services income without incurring any subpart F income under present law as the CFC may not be purchasing personal property from a related party nor performing services outside of its country of incorporation under present law rules. By creating a new category of subpart F income, foreign base company digital income, the Administration argues that it can appropriately tax mobile income earned from providing digital goods and services, thereby preventing future base erosion.

The proposal creates a subpart F category designed to capture income derived in connection with the use of intangible property developed by a related party where the CFC leases or sells a digital copyrighted article or provides a digital service. The proposal is similar to the foreign base company sales and services rules that capture income derived in connection with certain related party transactions involving the purchase or sale of personal property or the provision of services on behalf of a related party. The foreign base company sales income rules were designed to prevent a company from shifting profit to a CFC which acts as a conduit for either the purchase of personal property from a related party for sale to a third party or for the purchase of personal property from a third party for sale to a related party. The foreign base company sales income rules include exceptions for certain transactions occurring in the country where the CFC is created or organized. The foreign base company services income rules were designed to prevent a company from shifting profit to a CFC where the CFC is performing the services on behalf of a related party and where the services are performed outside the country where the CFC was created or organized. Some may argue that the digital economy presents the same potential for profit shifting as the sale of personal property where a CFC acts as a conduit for the sale or lease of digital goods or for the provision of digital services.

Similar to the foreign base company sales and services income rules, the proposal does not include income from the digital sale or provision of digital services where the CFC, through its own employees, makes a substantial contribution to the development of the property or services. However, the application of rules traditionally targeted at the purchase or manufacture of tangible property or the provision of services connected to a physical location or to specific tangible property may be difficult in the context of digital transactions.

A question could arise as to whether the proposal will rely on the substantial contribution language found in related subchapter F regulations.[70] For example, foreign base company sales income is excluded from subpart F income when a CFC substantially contributes to the manufacture of property to be sold by such CFC, through the activities of its employees, even if such property is manufactured through contract manufacturing.[71] It is unclear whether the proposal is, or should be, subject to the same substantial contribution requirements. Further, the proposal's inclusion of cost-sharing arrangements raises questions regarding when a CFC's substantial contribution to a subsequent version of intangible property is enough to meet the substantial contribution exception under the proposal. The efficacy of the proposal to counteract U.S. base erosion may depend on what constitutes sufficient activity within the CFC country, the circumstances under which activity in a branch is attributable to the CFC, as well as the scope of the definition of intangible property covered under the proposal.

The proposal includes an exception for income earned by the CFC directly from customers located in the CFC's country of incorporation that use or consume the digital copyrighted article or digital service in such country. This exception is similar to the exceptions from base company sales and services income provided under the present law subpart F rules, although it may be more difficult to determine where the digital copyrighted article or digital service is consumed. Clear guidelines for determining when income is considered to be derived from customers located in the same country and where the digital article or service is consumed are required to prevent the exception from undermining the proposal. For example, if a song or digital application is downloaded by a customer legally resident in Country A when the customer is physically present in Country B, is the customer located in Country A or Country B? Does the use or consumption of the song or application take place in country A or Country B?

Although the proposal is meant to provide subpart F rules to address and tax highly mobile income earned from providing digital goods and services, it is uncertain whether the proposal adequately considers ongoing concerns related to complex digital transactions that may have connection to several jurisdictions. The Administration and others believe that the ability to create highly mobile income in a digital economy allows taxpayers to move income to CFCs in low tax jurisdictions while inappropriately avoiding tax in higher tax jurisdictions where the income-earning value of a digital good or service is created. Using subpart F may be a viable

[70] Treas. Reg. sec. 1.954-3(a)(iv).

[71] Indicia of substantially contributing to the manufacture of a product include: (i) oversight and direction of the activities or process pursuant to how the property is manufactured; (ii) performance of activities that are considered but are insufficient to satisfy the "substantial transformation" or "substantive" tests; (iii) control of the raw materials, work-in-process, and finished goods; (iv) management of the manufacturing profits; (v) material or vendor selection; (vi) quality or logistic control; and (vii) directing development, protection, and use of trade secrets, technology, product design, design specification, and us of other intellectual property in the manufacturing process. Treas. Reg. sec. 1.954-3(a)(4)(iv)(b). See also, Lewis Greenwald *et al*., "The Fabulous New Substantial Contribution Test." *Journal of International Taxation*, vol. 19, October 2008, p.20.

alternative for addressing the complexities involved in taxing income derived from digital transactions.[72]

Proposals to tax highly-mobile, digital or intangible income

Commentators have noted the current inadequacy of the subpart F rules in addressing erosion of the U.S. tax base, and some have suggested alternative solutions for addressing the taxation of highly mobile income, including income from the digital economy. The difficulty of separating the income related to digital transactions from other types of transactions may lead to the conclusion that a broader solution, such as the Administration's proposal to tax excess returns,[73] is necessary to prevent base erosion and profit shifting. Commentators may also note that this proposal overlaps with the Administration's proposal to tax excess returns, and may question the necessity of two proposals which are similar in targeting income from intangible property developed by or transferred to a related party. If both proposals are enacted, rules would be necessary to address any potential overlap.

Proposals addressing highly mobile, digital, or intangible income provide different mechanisms for determining and taxing such income. The proposal seeks to tax income using a non-formulaic approach, by first defining income from transactions involving the sale or lease of digital copyrighted articles or from the provision of digital services, and then including such income as subpart F income. Chairman Camp, in his tax reform discussion draft, provided an alternative proposal for taxing intangible income.[74] Camp's discussion draft relies on a formula to separate intangible income from income that represents an ordinary return on tangible investments. Camp's discussion draft creates a new category of subpart F income called foreign base company intangible income, and includes in subpart F a percentage of a CFCs adjusted gross income representing a return to the enterprise beyond the expected return on certain tangible assets of the enterprise.[75] The Administration's excess returns proposal taxes excess intangible income which is defined as the excess of gross income connected with the covered

[72] The OECD Digital Economy Report suggests that considering CFC rules, such as the U.S. subpart F rules, is one of the actions the task force will consider in addressing the unique tax complexities of the digital economy. The OECD Digital Economy Report, pp. 119-120.

[73] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals* 45-46 (March 2014). For analysis of the proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal*, (JCS-2-12), June 2012, p. 338.

[74] See Chairman Camp's Discussion Draft: Tax Reform Act of 2014 ("Camp's discussion draft"), sec. 4211, Feb. 21, 2014.

[75] *Ibid*. Camp's discussion draft also provides the U.S. parent a partial deduction for foreign intangible income (both earned at the CFC and parent level) resulting in a lower tax rate for intangible income earned serving the foreign market.

intangible over the costs properly allocated and apportioned to the income increased by a percentage mark-up.[76]

Transfer pricing

In tailoring the proposal to apply to development by related parties, the proposal seeks to address the risks associated with current deference to related-party arm's-length transfer-pricing rules. Currently, a transfer price between related parties is respected when it represents an arm's-length price. The effectiveness of the arm's-length standard as the measure of transfer prices is often debated.[77] Following the leadership of the United States, most countries (including all of the member countries of the OECD) adopted and now follow the arm's-length standard.[78] The proposal avoids debate of the arm's length standard by addressing highly-mobile income shifting through subpart F, rather than through any direct changes to the transfer pricing rules.

The Administration and the OECD have not been in favor of moving away from computing income using the arm's-length standard. The OECD argues that such a move may not directly address flaws in the current global system, may increase the tax burden on legitimate active offshore businesses, and may have unclear behavioral effects on companies leading to investment decisions that are potentially not more efficient and tax-neutral.[79]

The OECD encourages the development of international rules that will (i) adopt a clear definition of intangibles; (ii) ensure that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with value creation; (iii) develop transfer pricing rules or special measure for transfers of hard-to-value intangibles, and (iv) update the guidance on cost contribution arrangements.[80] Such an approach would require international collaboration and enforcement. Similarly, with respect to the U.S. tax system, some commentators advocate

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[76] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals* 45-46 (March 2014). For analysis of the proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal,* (JCS-2-12), June 2012, p. 338.

[77] See *e.g.*, Marie Sapirie, "Arm's-Length Standard Contested at Ways and Means Hearing," *Tax Notes Today*, July 23, 2010, pp. 141-142 (reporting the remarks of Stephen Shay, Deputy Assistant Secretary for International Tax Affairs, U.S. Treasury Department).

[78] Notice 88-123, 1988-2 C.B. 458 (hereafter, the "Treasury White Paper"), p. 475. The Treasury White Paper was a study mandated by The Conference Report for the 1986 Act, H.R. Conf. Rep. No. 99-841, pt. 2 (hereafter "Conference Report 99-841"), II-638. For a discussion of the history of the arm's-length standard, which dates back to 1935, see Rueven S. Avi-Yonah, "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation," *Virginia Tax Review*, vol. 15, Summer 1995, p. 89.

[79] OECD Action Plan. See also, Kristen Parillo, "Intangible Asset Proposal Will Not Displace Transfer Pricing," *Tax Notes*, March 1, 2010, p. 1028; Barbara Angus, Stephen Bates, and Channing Flynn "New and Proposed International Tax Changes and U.S. Technology Industry: Clouds Parting on the Horizon?" *Tax Notes International*, Sept. 12, 2011, pp. 813, 817.

[80] OECD Action Plan*,* at 34-40.

unilateral action that would (i) create a clearer, more expansive definition of intangible property; and (ii) afford more authority to Treasury to require the valuation of transfers of intangible property on an aggregate basis, or on the basis of a realistic alternative principle.[81]

The OECD Digital Economy Report notes that many of the transactions and structures that facilitate BEPS in the digital economy rely on below-value transfers of intangibles.[82] Further OECD work in this area will focus on developing a broad and clear definition of what constitutes intangible property and guidelines to ensure that appropriate pricing is provided to entities that contribute to the development of the intangible. Additionally, the OECD will consider whether special measures, taking into account the post-transfer profitability of the intangible, will be provided. The OECD's focus on the appropriate pricing of transactions involving intangibles, proposals recommending a formulaic approach, and this proposal are intended to address the potential for BEPS in transactions involving highly-mobile, digital or intangible income.

Development of intangible property by related parties

Targeting development by a related party addresses the goal of reducing the financial incentives for transferring intangible property developed in the United States to a low-tax CFC. Noting that the potential for shifting income in a potentially abusive way is highest as a result of transactions between related parties, the Administration's proposal and others seek to tax CFC income in accordance with where value is created. The proposal seeks to impose tax when a CFC uses intangible property developed by a related party (including property developed pursuant to a cost sharing arrangement) to produce the income and the CFC does not, through its own employees, make a substantial contribution to the development of the property or services that give rise to the income. Determining when taxation occurs under the proposal thus requires analysis as to when a (i) CFC uses intangible property developed by a related party, and (ii) whether a CFC, through its own employees, makes a substantial contribution to the development of the property or services giving rise to income.

The expansion of subpart F to require current taxation of income related to digital goods and services, where the intangible property is developed by a related party, may reduce the incentive for taxpayers to engage in these related party transactions. One general tenet of the U.S. taxing system and the transfer pricing rules is to allocate income to where the economic value creation occurs. Proponents may argue that the proposal prevents a CFC with little economic activity from benefiting from the use of intangible property developed by a related party.

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[81] See sec. 81, Chairman Baucus Staff International Tax Reform Discussion Draft, November 19, 2013. The realistic alternative principle is predicated on the notion that a taxpayer will only enter into a particular transaction if none of its realistic alternatives is economically preferable to the transaction under consideration. For example, existing regulations provide the IRS with the ability to determine an arm's-length price by reference to a transaction (such as the owner of intangible property using it to make a product itself) that is different from the transaction that was actually completed (such as the owner of that same intangible property licensing the manufacturing rights and then buying the product from the licensee).

[82] The Digital Economy Report, p.117.

On the other hand, others may argue that the proposal may encourage multinational corporations to locate activities that produce high-value intangible assets offshore from the beginning of the development process rather than to risk the application of the proposal if the resulting intangible property is used by the CFC. This can be accomplished by performing more research and development activities outside the United States from the inception of a project. Alternatively, the CFCs may retain related party U.S. entities to perform contract research and development services on their behalf. In the latter instance, research and development jobs may be retained in the United States but the return to the U.S. entity related to its research and development activities may be reduced to reflect only the profit attributable to the labor and not the profit attributable to the production of a high-value intangible asset in accordance with the arms-length transfer pricing rules of section 482.

There may be other important considerations in selecting the physical location for research and development, as well as selecting the legal entity that funds and bears the risk of research and development. For example, access to, and retention of, qualified scientists, and research incentives such as the U.S. research credit may be important reasons for companies to locate research and development activities in the United States. In addition, the deductions for research and development activities in a low-tax jurisdiction are worth less than deductions incurred in a high tax jurisdiction. Therefore, taxpayers have an incentive to be selective when identifying projects for foreign development, and to choose only those projects with the highest likelihood for success. Nonetheless, taxpayers may increase foreign research and development activities by CFCs to avoid current taxation under the proposal.

Transfers made in conjunction with cost-sharing arrangements present a unique issue. With cost sharing, existing intangible property is often used as the platform from which the next generation intangible property is developed. For example, assume a U.S. company transfers version 1.0 to its CFC as part of a cost-sharing arrangement. This initial platform contribution requires compensation by the CFC, which is entitled to (1) the foreign "make and sell" rights during the useful life of version 1.0, (2) the right to develop version 2.0 from version 1.0, and (3) economic ownership of the foreign rights to version 2.0. To the extent that the CFC avails itself of the intangible property by making and selling version 1.0 products, the proposal should work to include the CFC's income from the use of these version 1.0 products.

On the other hand, upon the successful development of version 2.0, it is unclear to what extent production of version 2.0 products should be considered as use of the version 1.0 product developed by the related party. Although the nexus between version 1.0 and version 2.0 may be sufficient to warrant the subpart F inclusion under the proposal, it is unclear whether it should also continue in perpetuity as subsequent versions (3.0, and so forth) are developed.

Arguably, treating any version 1.0 progeny as a use of intangible property developed by a related party under the proposal, without regard to the actual useful life or usefulness of version 1.0, mitigates any financial incentive of U.S. parents to cost-share intangible property development with its CFC. On the other hand, if the proposal does not specify how to treat subsequently developed versions, determining whether a subsequently developed version has sufficient nexus to the original intangible may require a case-by-case analysis. Such an analysis would entail significant administrative burdens on both taxpayers and the IRS.

M. Prevent Avoidance of Foreign Base Company Sales Income Through Manufacturing Service Arrangements

Present Law

Introduction

The United States has a worldwide tax system under which U.S. corporations are generally taxed on all income, whether derived in the United States or abroad. Income earned indirectly by a domestic corporation through a foreign subsidiary is generally subject to U.S. tax only when the income is distributed to the domestic parent corporation. Deferral of U.S. tax is permitted for most types of active foreign business income. However, this deferral is limited by anti-deferral regimes that impose current U.S. tax on certain types of income earned by certain corporations. These anti-deferral rules are intended to prevent taxpayers from avoiding U.S. tax by shifting passive or other highly mobile income into low-tax jurisdictions.

The main anti-deferral regime of relevance to U.S. corporations is subpart F, which is applicable to controlled foreign corporations ("CFCs") and their shareholders.[83] A controlled foreign corporation is generally defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).[84] Under the subpart F rules, the United States generally taxes the 10-percent U.S. shareholders of a CFC on their pro rata shares of certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is distributed to shareholders.[85]

With certain exceptions, subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income, insurance income, and certain income relating to international boycotts and other violations of public policy. Foreign base company income consists of foreign base company sales income, foreign base company services income, foreign personal holding company income, and foreign base company oil-related income.[86] The rules for foreign base company sales income and foreign base company services income are described below.[87]

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[83] Secs. 951-964.

[84] Secs. 951(b), 957, 958.

[85] Secs. 951(a).

[86] Sec. 954.

[87] For an expanded discussion of subpart F, see Joint Committee on Taxation, *Present Law and Issues in U.S. Taxation of Cross-Border Income* (JCX-42-11), September 6, 2011.

Foreign base company sales income

Foreign base company sales income consists of income (whether in the form of profits, commissions, fees, or otherwise) derived by a CFC in connection with: (1) the purchase of personal property from a related person and its sale to any person; (2) the sale of personal property to any person on behalf of a related person; (3) the purchase of personal property from any person and its sale to a related person; or (4) the purchase of personal property from any person on behalf of a related person. In each of the situations described in items (1) through (4), the property must be both (1) manufactured, produced, grown, or extracted outside the CFC's country of incorporation and (2) sold for use, consumption, or disposition outside of that same country for the income from its sale to be considered foreign base company sales income.[88] If the personal property does not satisfy both of these conditions then the income generated from its sale is not considered foreign base company sales income. Consequently, foreign base company sales income does not include income from the sale of property that the CFC, or any related or unrelated party, has manufactured in the CFC's country of incorporation.[89] Moreover, foreign base company sales income does not include income derived in connection with the sale of personal property manufactured, produced, or constructed by the CFC (the "manufacturing exception"). Treasury regulations, described below, establish conditions under which a CFC can qualify for the manufacturing exception, even if physical manufacturing activities have not been performed by the CFC's employees.

Manufacturing exception

A CFC can qualify for the manufacturing exception if it meets one of the three tests: the substantial transformation test, the substantial activity test, or the substantial contribution test.[90]

Substantial transformation test

Under the substantial transformation test, a CFC is considered to have manufactured a product if it purchases and "substantially transforms" personal property prior to its sale. This requirement involves, for example, the transformation of raw materials into a finished product, such as processing and converting wood pulp into paper or the transformation of steel rods to screws.[91]

[88] Sec. 954(d)(1). For purposes of this section, personal property does not include agricultural commodities that cannot be grown in the United States in commercially marketable quantities. A list of these commodities is provided in Treas. Reg. sec. 1.954-3(a)(ii)(b).

[89] This exception is sometimes referred to as the "same-country manufacturing exception."

[90] Treas. Reg. sec 1.954-3(a)(4).

[91] Treas. Reg. sec. 1.954-3(a)(4)(ii).

Substantial activity test

Under the substantial activity test, a CFC is considered to have manufactured a product through the assembly or conversion of component parts, provided the activities are substantial in nature and generally considered to constitute the manufacture, production or construction of property.[92] Under this second test, a safe harbor presumes the CFC will have manufactured a product if its conversion costs account for at least 20 percent of the total cost of goods sold (*i.e.*, direct labor and factory burden).[93] Conversion costs exclude costs for packaging, repackaging, labeling, and minor assembly operations, as these activities are not considered to constitute manufacturing activities.[94]

Substantial contribution test

The substantial contribution test establishes conditions under which a CFC can be said to have manufactured property, for purposes of the foreign base company sales income rules, even if it has not performed any physical manufacturing of the property. A CFC meets the substantial contribution test if the CFC makes a substantial contribution, through its own employees, to the manufactured property that it sells.[95] To qualify for the manufacturing exception under this test, the personal property must still have undergone a physical manufacturing process. However, it is not necessary for any of the CFC's direct employees to perform the actual physical manufacturing activities. Rather, the CFC can meet the manufacturing exception by making a substantial contribution to physical manufacturing through certain manufacturing-related activities of its employees.

Treasury regulations provide a non-exhaustive list of activities to be considered when determining whether a CFC meets the substantial contribution test. These activities are the: (1) oversight and direction of manufacturing activities or process pursuant to which the property is manufactured, produced, or constructed; (2) performance of activities that are considered in, but that are insufficient to satisfy, the substantial transformation or substantial activities tests; (3) material selection, vendor selection, or control of the raw materials, work-in-process, or finished goods; (4) management of manufacturing costs or capacities; (5) control of manufacturing-related logistics; (6) quality control; and (7) developing, or directing the use or development of, product design and design specifications, as well as trade secrets, technology, or other intellectual property for the purpose of manufacturing, producing, or constructing the personal property.[96]

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[92] Treas. Reg. sec. 1.954-3(a)(4)(iii).

[93] *Ibid*.

[94] *Ibid*.

[95] Treas. Reg. sec. 1.954-3(a)(4)(iv).

[96] Treas. Reg. sec. 1.954-3(a)(4)(iv)(b).

Of these categories, there is no single overriding or controlling factor. Instead, it is a facts and circumstances determination that depends on the economic importance of the activity to the manufacture of the product.[97] In addition, the ownership of the raw materials is not relevant in the determination, such that there is no distinction between consignment manufacturing, where the CFC maintains title and risk of loss with respect to the raw materials, and traditional contract manufacturing.[98] In general, the location of the manufacturing activity will be where the CFC makes its contribution through its employees.[99] The CFC cannot satisfy the substantial contribution test on the basis of anyone in an agency relationship with the CFC; rather, its own employees, as that term is defined for U.S. tax purposes, must conduct the relevant activities.[100] Similarly, the activities of a person employed by the CFC's disregarded entity ("DRE") are only taken into account if that person is considered an employee of the DRE under the U.S. tax definition of "employee." There are no safe harbor provisions,[101] and both the substantial contribution and branch manufacturing analyses are made on a product-by-product basis.[102] Furthermore, mere contractual rights, legal title, tax ownership, and assumption of economic risk of loss are not considered when determining whether there is substantial contribution.[103]

Branch rules

In general

Special branch rules may apply in cases in which a CFC carries on purchasing, selling, or manufacturing activities outside its country of organization through a branch or similar establishment (referred to hereafter as a "branch").[104] If the branch is treated as a separate corporation under the sales branch rules, purchasing and sales income derived by the branch generally will be foreign base company sales income. Similarly, if there is a manufacturing branch that is treated as a separate corporation, purchasing and sales income derived by the remainder of the CFC and foreign sales branches of the CFC generally will be foreign base

[97] Treas. Reg. sec. 1.954-3(a)(4)(iv)(c).

[98] Treas. Reg. sec. 1.954-3(a)(4)(iv)(d), Example 3.

[99] Treas. Reg. sec. 1.954-3(b)(1)(i)(c)(3)(iv).

[100] T.D. 9438, 2009-5 I.R.B. 387, February 2, 2009, Preamble, Summary of Comments and Explanation of Provisions, A.4.

[101] T.D. 9438, 2009-5 I.R.B. 387, February 2, 2009, Preamble, Summary of Comments and Explanation of Provisions, A.3.

[102] T.D. 9438, 2009-5 I.R.B.. 387, February 2, 2009, Preamble, Summary of Comments and Explanation of Provisions, A.5.

[103] T.D. 9438, 2009-5 I.R.B.. 387, February 2, 2009, Preamble, Summary of Comments and Explanation of Provisions, A.2.b.

[104] Sec. 954(d)(2); Treas. Reg. sec. 1.954-3(b).

company sales income. The branch rules address situations in which income derived by selling activities has been separated from income derived by manufacturing activities for purposes of obtaining a lower tax rate on the sales income.[105] The rules apply, however, only if the use of the branch has substantially the same tax effect as if it were a separate corporation. Whether use of the branch has substantially the same tax effect as if it were a separate corporation is determined under regulations, and is based on a tax rate disparity test.

Under the sales branch rule, the tax rate disparity test assumes that the manufacturing operation is retained by the CFC and evaluates whether the selling activities have been shifted to a selling branch to obtain a lower tax rate on the selling income.[106]

While section 954(d)(2) expressly provides a branch rule for purchasing or sales activities occurring outside the CFC's country of organization, it does not expressly provide a manufacturing branch rule, which is provided only in regulations. Under the regulations, if the conduct of manufacturing[107] activities by or through a branch located outside the CFC's country of organization has the same tax effect as if such branch were a separate corporation, then the branch and the remainder of the CFC will be treated as separate corporations for purposes of determining whether the CFC has foreign base company sales income.[108] As with the sales branch rule, whether use of the branch has substantially the same tax effect as if it were a separate corporation is determined based on a tax rate disparity test. This test assumes that the selling operation is retained by the CFC—in contrast with the sales branch rule's assumption that the manufacturing operations is retained by the CFC—and compares the tax rate imposed on the sales income by the CFC's country of organization to the tax rate that would have been charged had the sales income been recognized in the country where the manufacturing branch is located.[109]

The tax rate disparity tests differ slightly under the two branch rules. Under the sales branch rule, the sales branch is treated as a separate corporation if the effective tax rate on its sales income is less than 90 percent of, and at least five percentage points less than, the effective tax rate that would apply to that same income if it had been earned in the CFC's country of incorporation (*i.e.*, where the manufacturing income is earned).[110] Thus, the test looks to whether the effective tax rate of the branch is too low in comparison to the effective tax rate of the CFC.

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[105] H.R. Report No. 1447, 87th Congress 2nd Session; H.R. 10650, at par. XIV.B.4; see also Senate Report No. 1881, 87th Congress 2nd Session; H.R. 10650, par. XII.C.3.b.

[106] Treas. Reg. sec. 1.954-3(b)(1)(i).

[107] As used here, "manufacturing" includes producing, constructing, growing or extracting activities. Treas. Reg. sec. 1.954-3(a)(2).

[108] Treas. Reg. sec. 1.954-3(b)(1)(ii).

[109] Treas. Reg. sec. 1.954-3(b)(1)(ii).

[110] Treas. Reg. sec. 1.954-3(b)(1)(i)(b).

In contrast, under the manufacturing branch rule, the manufacturing branch is treated as a separate corporation if the effective tax rate on the CFC's sales income[111] is less than 90 percent of, and at least five percentage points less than, the effective tax rate that would apply to such sales income in the country in which the branch is located.[112] Thus, the test looks to whether the effective tax rate of the CFC is too low in comparison to the effective tax rate of the manufacturing branch.

In each case, several distinct assumptions are made in determining the allocation of income to the branch and to the nonbranch income of the CFC.[113]

Multiple manufacturing and sales branches

For purposes of applying the branch rule in cases involving multiple manufacturing and sales branches, Treasury regulations provide guidance for determining the location of manufacturer and the rules for applying the tax rate disparity test.

A CFC performing manufacturing activities in multiple locations will be considered as having a single manufacturing location for purposes of applying the tax rate disparity test. If any single location independently satisfies any of the manufacturing tests, that location is treated as the manufacturing location.[114] If there are multiple locations that independently satisfy either of the physical manufacturing tests, or substantial contribution test, the location of manufacturing is the location with the lowest effective tax rate.[115] If there are multiple locations but no single location independently satisfies a manufacturing test, but together they provide a substantial contribution to the manufacture of the product, then the manufacturing location will be deemed to be the location of sale or purchase if a "demonstrably greater" amount of the CFC's activities contributing to the manufacture of the product occur in jurisdictions with no tax rate disparity (as that term is used in this context) relative to the sale and purchase location than occur in other jurisdictions.[116]

Otherwise, the location of manufacture will be deemed to be the location imposing a tax rate that is sufficiently greater than the rate imposed on the sales income, thereby creating a tax rate disparity (as that term is used in this context) relative to the sales and purchases income.[117] In the first case (*i.e.*, the manufacturing location is deemed to be the location of sale or

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[111] This is commonly referred to as the "remainder of the CFC."

[112] Treas. Reg. sec. 1.954-3(b)(1)(ii)(b).

[113] Treas. Reg. secs. 1.954-3(b)(1)(i)(b) and 1.954-3(b)(1)(ii)(b).

[114] Treas. Reg. sec. 1.954-3(b)(1)(ii)(c)(1).

[115] *Ibid*.

[116] Treas. Reg. sec. 1.954-3(b)(1)(i)(c)(3)(iii).

[117] *Ibid*.

purchase), no foreign base company sales income will result. In the latter case (*i.e.*, the location of manufacture is the location with excessive tax rate disparity, as that term is used in this context, relative to the sales and purchase location), foreign base company sales income may result.

For purposes of the branch rule, the location in which activities take place is where the relevant personnel are when they perform such activities, not the location of the employing company.[118]

Foreign base company services income

Foreign base company services income consists of income derived in connection with technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services performed outside the CFC's country of incorporation for or on behalf of a related party.[119] This includes "substantial assistance" contributing to the performance of services by a CFC that has been furnished by a related person or persons.[120] Substantial assistance consists of assistance furnished (directly or indirectly) by a related person or persons to the CFC if the assistance satisfies an objective cost test. For purposes of the objective cost test, the term "assistance" includes, but is not limited to, direction, supervision, services, know-how, financial assistance (other than contributions to capital), and equipment, material, or supplies provided directly or indirectly by a related U.S. person to a CFC. The objective cost test will be satisfied, and foreign base company services income will generally result, if the cost to the CFC of the assistance furnished by the related person or persons equals or exceeds 80 percent of the total cost to the CFC of performing the services.[121]

Exceptions

Foreign base company services income does not include income derived in connection with the performance of services that are directly related to (1) the sale or exchange by the CFC of property manufactured, produced, grown, or extracted by it and that are performed before the time of the sale or exchange, or (2) an offer or effort to sell or exchange such property.[122] In addition, foreign base company services income does not include exempt insurance income,[123]

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[118] Treas. Reg. sec. 1.954-3(b)(1)(i)(c)(3)(iv).

[119] Sec. 954(e).

[120] Treas. Reg. sec. 1.954-4(b)(1)(iv).

[121] Notice 2007-13, 2007-5 I.R.B. 410. Prior to the issuance of the Notice, the substantial assistance rules also included a subjective principal element test. Under the subjective principal element test, assistance in the form of direction, supervision, services or know-how were considered substantial if the assistance provided the CFC with skills which where were a principal element in producing the income from the performance of such services by the CFC.

[122] Sec. 954(e)(2).

[123] Secs. 954(e)(2) and 953(e).

qualified banking or financing income,[124] qualified insurance income,[125] or income not treated as foreign personal holding company income by reason of the dealer exception.[126]

Description of Proposal

Under the proposal, the definition of foreign base company sales income is expanded to include income of a CFC from the sale of property manufactured on behalf of the CFC by a related person. The existing exceptions to foreign base company sales income would continue to apply.

Effective date.−The proposal would be effective for taxable years beginning after December 31, 2014.

Analysis

Global dispersion of production

Reductions in transportation costs, improvements in information and communication technologies, and modernization in the economic infrastructure of countries around the world have contributed to the decline of vertically integrated production networks, where one company controls and conducts all aspects of the production of its goods in-house. Instead, production has become more dispersed geographically as companies exploit the economic advantages—including lower costs and workforce expertise—of manufacturing their products in certain countries and through firms that specialize in manufacturing certain types of products.[127] Often, this occurs through arrangements made with contract manufacturers, which generally refers to a situation where one company—the contract manufacturer—agrees to manufacture a product for another company—the principal—based on the principal's specifications and direction. The contract manufacturer may be related or unrelated to the principal, and contract manufacturers are located in both developed and developing countries, with developed countries increasingly specializing in activities performed by high-skilled workers, and emerging market countries increasingly performing capital-intensive activities.[128]

Contract manufacturing arrangements

There are two broad categories of contract manufacturing arrangements: consignment (toll) arrangements and buy-sell (turnkey) arrangements. The underlying economic substance of

[124] Secs. 954(e)(2) and 954(h).

[125] Secs. 954(e)(2) and 954(i).

[126] Secs. 954(e)(2) and 954(c)(2)(C)(ii).

[127] Marcel P. Timmer, Abdul Azeez Erumbam, Bart Los, Robert Stehrer, and Gaaitzen J. de Vries, "Slicing Up Global Value Chains," *Journal of Economic Perspectives*, vol. 28, no. 2, Spring 2014, pp. 99-118.

[128] *Ibid*.

these arrangements is similar. In both arrangements, the contract manufacturer generally owns the plant and equipment used to manufacture a product, while the principal holds title to the finished product and bears the financial risk (*i.e.*, potential profit or loss) associated with its sale. The contract manufacturer bears the risk associated with manufacturing the product to the specifications set forth by the principal, among other risks. The contract manufacturer typically receives a service fee for the risk that it bears, while the principal is entitled to the residual gain or loss from selling the product after it has compensated the contract manufacturer for its services and the cost of manufacturing the product.

What distinguishes consignment manufacturing from buy-sell manufacturing is the entity—the principal or the contract manufacturer—that holds title to the raw materials, components, and work in process as the product is being manufactured. The principal holds title in a consignment arrangement, while the contract manufacturer holds title in a buy-sell arrangement. For example, in a consignment arrangement, the principal may purchase the raw materials and components used to manufacture a product and consign them to the contract manufacturer, who then uses them to make the finished product. The principal need not purchase the raw materials and components directly to hold title to them; it may still hold title if the contract manufacturer purchases the raw materials and components on behalf of the principal. In contrast, under a buy-sell arrangement, the contract manufacturer usually buys the raw materials and components used to make the product, and then sells (*i.e.*, transfers title of) the finished product for a price typically equal to the cost of manufacturing the product plus a service fee.

Policy concerns and the Administration's proposal

CFCs may find it prohibitively difficult to meet the physical manufacturing tests of the manufacturing exception—the substantial transformation and substantial activities tests—under typical contract manufacturing arrangements; a CFC generally enters a contract manufacturing arrangement in the first place because it wants another party to perform physical manufacturing activities. Recognizing that "the use of contract manufacturing arrangements has become a common way of manufacturing products because of the flexibility and efficiencies it affords," Treasury established the substantial contribution test of the manufacturing exception as a way for CFCs to earn tax-deferred income on the sale of certain property produced through a contract manufacturing arrangement.[129] However, according to a Treasury official, the Administration is concerned that companies have "manipulated the form" of certain contract manufacturing arrangements "to avoid the application of current law."[130] The Administration is specifically concerned with certain related-party contract manufacturing arrangements, and its proposal circumscribes the scope of contract manufacturing arrangements that may satisfy the substantial contribution test by including in the category of foreign base company sales income that income a CFC earns through the sale of property manufactured by a related person on its behalf. It is

[129] Department of the Treasury, REG-124590-08, "Guidance Regarding Foreign Base Company Sales Income," *Federal Register*, vol. 73, no. 40, February 28, 2008, 10716.

[130] Kristen A. Parillo and Andrew Velarde, "Obama Budget's International Tax Provisions Reflect BEPS Concerns," *Tax Notes*, March 10, 2014, pp. 1035-1038.

presumed that the Administration's proposal retains the substantial contribution test, so that a CFC may still earn tax-deferred income from sale of property produced by a related contract manufacturer if it has made a substantial contribution to physically manufacturing that property. In addition, it is presumed that the Administration's proposal does not apply to income from the sale of property produced on behalf of a CFC by an unrelated contract manufacturer, or produced in the CFC's country of incorporation by a related contract manufacturer.

In motivating the Administration's proposal, a Treasury official has explained that Administration is concerned with cases where taxpayers "take what would have traditionally been a buy-sell contract manufacturing arrangement among related parties, flip it into a services arrangement," and, in doing so, "avoid the application of current law, which is really designed to reach the substance of the economic relationship there."[131] The Administration may be referring to the tax-driven structuring of what would naturally be a buy-sell manufacturing arrangement to a consignment manufacturing arrangement. Although the Administration's description of its proposal does not provide a detailed example of the type of transactions it is targeting, the following two highly stylized examples may offer some general insight into some of the Administration's policy concerns.

Buy-sell manufacturing example

First, consider a case where a principal CFC incorporated in the Cayman Islands ("CFC1") enters into a buy-sell manufacturing arrangement with a related manufacturing CFC located in Germany ("CFC2") to make a particular product ("X"). CFC1 and CFC2 have a common parent, ParentCo. As part of the arrangement, assume that CFC2 purchases, from unrelated parties, all the raw materials and components used to manufacture X and holds title to X as it is being manufactured, based on CFC1's specifications. All physical manufacturing is performed in Germany by CFC2 and is done so without a substantial contribution from CFC1. CFC2 sells the finished product to CFC1 for a price equal to the cost incurred by CFC1 to make X plus a fee for the risk that it undertook in the process of manufacturing X. CFC1 proceeds to sell the product to unrelated customers outside the Cayman Islands. Based on the facts in this example, income earned by CFC1 from the sale of X is foreign base company sales income because CFC1 is selling property that it has purchased from a related party without having made a substantial contribution to manufacturing that property.

Consignment manufacturing example

In contrast, consider an example with facts similar to the one above. In this case, CFC1 enters into a consignment manufacturing arrangement—as opposed to a buy-sell manufacturing arrangement—with CFC2 to produce X. As part of the arrangement, CFC1 purchases, from unrelated parties, all the raw materials and components used to make X and consigns them to CFC2 for use in manufacturing X, based on CFC1's specifications. CFC1 holds title to X as it is being manufactured. All physical manufacturing is performed in Germany by CFC2 and is done so without a substantial contribution from CFC1. CFC1 obtains the finished product from CFC2

[131] Kristen A. Parillo and Andrew Velarde, "Obama Budget's International Tax Provisions Reflect BEPS Concerns," *Tax Notes*, March 10, 2014, pp. 1035-1038.

and pays CFC2 an amount equal to the cost incurred by CF2 to make X plus a fee for the risk that it undertook in the process of manufacturing X. CFC1 proceeds to sell the property to unrelated customers outside the Cayman Islands.

The Administration argues that "[u]nder current law, taxpayers take the position that a CFC can avoid foreign base company sales income by structuring the related party transaction by which the CFC obtains the property that the CFC sells to customers as the provision of a manufacturing service to the CFC rather than as a purchase of the property by the CFC."[132] In the context of this consignment manufacturing example, the Administration may be concerned with the case where taxpayers claim that CFC1 has not earned foreign base company sales income because it has received a manufacturing service from CFC2 and did not acquire the property by purchasing it from CFC1. All income earned by CFC1 from its sale of X is tax-deferred under this position.[133]

Discussion of the Administration's policy concerns

The transaction costs of restructuring the buy-sell manufacturing arrangement as a consignment manufacturing arrangement in the examples above may be relatively small. For example, since CFC1 and CFC2 are controlled by the same parent, the parent may have significant flexibility in determining which CFC purchases the raw materials and components used to manufacture X and which CFC holds title to raw materials, components, and work-in-process as X is being manufactured.

Given the potentially small planning costs of restructuring the contract manufacturing arrangement, if foreign base company sales income is earned in the buy-sell manufacturing example but not in the consignment manufacturing example, that may raise number of possible policy concerns. First, the ability of taxpayers to successfully avoid the foreign base company sales income rules in the consignment manufacturing example may encourage companies to channel more sales through low-tax jurisdictions for no economically substantive reason. This may be especially true if there are relatively small transaction costs of setting up affiliates in low-tax jurisdictions to sell products made in other jurisdictions, or of arranging for an existing low-tax affiliate to sell products currently being sold by affiliates in high-tax jurisdictions. Second, and along similar lines, the tax result undermines one of the policy goals of the foreign base company sales income rules, which is to deter tax-motivated splits of manufacturing and sales operations.[134] Third, to the extent that the economics of the buy-sell manufacturing example and

[132] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals*, March 2014, p. 60. The Administration has not elaborated on the extent to which taxpayers have taken this position or argued for it successfully.

[133] The foreign base company services income rules are not implicated in this example because CFC2 performed all its manufacturing services in its country or incorporation, Germany.

[134] The legislative history behind the foreign base company sales income provision indicates that the sales income of primary concern to Congress was the "income of a selling subsidiary (whether acting as a principal or agent) which has been separated from manufacturing activities of a related corporation merely to obtain a lower rate of tax for the sales income." S. Rep. No. 1881, 87th Congress, 2d session, at 84 (1962).

the consignment manufacturing example are economically similar, it is unclear what tax policy principle, if any, supports allowance of deferral for sales income earned in one case but not the other. In both examples, property produced by a related party was obtained by a CFC that did not make a substantial contribution to manufacturing that property. Under this view, while it is true that manufacturing CFC bears less risk (*e.g.*, the risk of loss due to defects in the raw materials) in the consignment manufacturing example than in the buy-sell manufacturing example, that should reduce the service fee the manufacturing CFC receives for the risk it bears but should not affect the U.S. tax treatment of sales income earned by the principal CFC.

The Administration's proposal addresses these policy issues by treating sales income earned in the consignment manufacturing example as foreign base company sales income. The Administration points out that the concerns "that underlie the foreign base company sales income rules, including concerns about U.S. base erosion, apply with respect to income earned by a CFC from the sale of property produced by a related party, regardless of whether the CFC is characterized as obtaining the property through a purchase transaction or through a manufacturing service."[135] Under this view, the manner in which a CFC acquires property produced by related party is not relevant. Sales income earned in the consignment manufacturing example should be treated as foreign base company sales income, just as it is in the buy-sell manufacturing example.

Critique of the Administration's proposal

Some commentators have argued that the Administration's proposal hinders the global competitiveness of U.S. multinationals by narrowing the scope of contract manufacturing arrangements that a CFC may enter into without having its sales income in foreign markets subject to current U.S. taxation, while the sales income of foreign competitors in the same markets may be qualify for exemption, or limited taxation, in their home country on a broader range of contract manufacturing arrangements.[136] However, others may respond that the existing foreign base company rules already balance the goal of promoting the competitiveness of U.S. multinationals with the goal of protecting the U.S. tax base by allowing companies to defer U.S. tax liability on foreign sales income from certain property when they make a substantial contribution to the manufacture of that property in a contract manufacturing arrangements. In other words, the rules recognize the importance of contract manufacturing in the global operations of U.S. multinationals by allowing sales income to qualify for the manufacturing exception even if the CFC selling a given piece of property did not engage in the direct physical manufacture of that property through its employees. The rules may also reflect a policy judgment that a CFCs should, through its employees, make at least some contribution, even if non-physical, to the physical manufacture of the property to be considered as having manufactured the product under the manufacturing exception.

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[135] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals*, March 2014, p. 60.

[136] Lowell D. Yoder, "President's Budget Would Apply Subpart F to Toll Manufacturing Arrangements," *Tax Management International*, vol. 43, no. 8, August 8, 2014, pp. 496-497.

Critics have also pointed out that the Administration's proposal may discourage U.S. multinational corporations from relying on U.S. contract manufacturers because it makes it less profitable to do so.[137] This may reduce employment and investment in the United States. In fact, some commentators have argued that existing subpart F rules already bias U.S. multinational corporations against using U.S. contract manufacturers.[138] Supporters of the proposal may argue that the proposal should not affect third-party contract manufacturing arrangements because it does not apply to property produced on behalf of a CFC by third-party U.S. contract manufacturers. Moreover, in the related-party manufacturing context, sales income earned by CFCs of U.S. multinationals may still satisfy the manufacturing exception as long as the CFC makes a substantial contribution to the physical manufacture of the property.

For some commentators, one way to address the disparate tax results obtained in the purchase transaction and service transaction examples, and promote U.S. manufacturing and the competitiveness of U.S. multinationals, is to eliminate the foreign base company sales income rules altogether.[139] However, some may say that this will likely facilitate tax avoidance and result in substantial shifting of income to low-tax or zero-tax jurisdictions, reducing U.S. tax collections and potentially encouraging companies to shift their U.S.-based sales and manufacturing operations abroad.

N. Restrict the Use of Hybrid Arrangements that Create Stateless Income

Present Law

Deductions for interest and royalties

A deduction is allowed for interest paid or accrued on indebtedness, including on indebtedness incurred in carrying on any trade or business.[140] The deduction for interest is subject to a number of restrictions, including the earnings stripping rules for some related-party interest.[141]

A deduction is allowed for royalties paid or incurred for the use of property in carrying on any trade or business.[142]

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[137] *Ibid.*

[138] Martin A. Sullivan, "U.S. Contract Manufacturing And Dave Camp's Option C," *Tax Notes*, April 1, 2013, pp. 10-14.

[139] Lowell D. Yoder, "President's Budget Would Apply Subpart F to Toll Manufacturing Arrangements," *Tax Management International*, vol. 43, no. 8, August 8, 2014, pp. 496-497.

[140] Secs. 162, 163. The section 162 deduction is for all ordinary and necessary expenses paid or incurred in carrying on any trade or business.

[141] Sec. 163(j).

[142] Sec. 162.

Hybrid instruments, hybrid transfers, and hybrid entities

The tax laws of the United States may treat a particular cross-border arrangement differently from the arrangement's treatment under the tax laws of another country. The proposal refers to the different tax treatment of a particular arrangement under the laws of the United States and the laws of one or more other countries as a hybrid arrangement. The proposal mentions in particular three categories of hybrid arrangements – hybrid instruments, hybrid transfers, and hybrid entities.

Hybrid instruments are financial instruments that are classified differently under the tax laws of United States from their classification under the tax laws of another country. For example, an instrument that is treated as indebtedness under the laws of the United States may be treated as equity under the laws of another country.

Hybrid transfers are transactions related to property, such as stock or indebtedness, that are characterized differently under U.S. tax law and foreign tax law. For example, in a sale-repurchase ("repo") transaction one party to the transaction (the "repo seller") sells stock or other property to the other party to the transaction (the "repo buyer") for cash and promises to repurchase the stock or other property at an agreed date in the future for an agreed price that is typically higher than the original purchase price. The United States generally treats this repo in accordance with its substance, that is, as a cash loan of the purchase price from the repo buyer to the repo seller, with the transferred securities serving as collateral for the repo seller's obligation to repurchase the stock or other property. Another country might respect the form of the transaction and, as such, treat the repo as the repo seller's sale of stock or other property to the repo buyer at the outset of the transaction and as the repo seller's repurchase of that stock or other property at the close of the transaction.

Hybrid entities are business entities that are classified differently under the tax laws of the United States and another country. For example, U.S. tax law may treat a business entity as a partnership or as disregarded as an entity separate from its sole owner while under the taxation laws of a foreign country the entity is classified as a separately taxable corporation. From the U.S. perspective, this entity would be referred to as a "hybrid entity." Alternatively, the U.S. tax rules might treat an entity as a separately taxable corporation while foreign tax law might classify the same entity as fiscally transparent (as, for example, a partnership). From the U.S. perspective, this entity would be referred to as a "reverse hybrid entity." Here the term "hybrid entity" is used to refer to any business entity that is classified differently under the laws of the United States and another country. The U.S. elective entity classification, or "check-the-box," rules have facilitated the proliferation of hybrid entities.[143]

When a U.S. taxpayer that is a party to a hybrid arrangement makes a payment according to the terms of the arrangement, the payment may be deductible in the United States even though the other party to the arrangement is not taxed on the receipt of the payment. For example, in the

[143] For a description of the check-the-box rules, see Joint Committee on Taxation, *Present Law and Background Related to Proposals to Reform the Taxation of Income of Multinational Enterprises* (JCX-90-14), July 21, 2014, pp 6-7.

case of the indebtedness-equity hybrid instrument described previously, the United States may allow an interest deduction when the U.S. taxpayer that is party the instrument makes payments on the instrument, and the country of residence of the other party to the instrument may not treat receipt of payments on the instrument as income because it treats the payments as exempt dividends in respect of equity. Under the repo transaction described previously, if the repo seller is a U.S. taxpayer and the repo buyer is a resident of another country, the United States may allow a deduction to the repo seller for a deemed amount of interest because it treats the repo as a cash loan from the repo buyer to the repo seller, while the country of residence of the repo buyer may not require the buyer to include a corresponding amount in income because it does not treat the transaction as a loan.[144] In the case of hybrid entities, assume that a foreign parent company resident in country y ("FPy") has a subsidiary resident in country x ("FSx") and that that subsidiary has a U.S. subsidiary ("USS"). Assume that the tax laws of the United States and country y treat FSx as a separately taxable corporation and that the tax law of country x treat FSx as fiscally transparent. If FSx makes a loan to USS and USS pays interest on the loan to FSx, the United States may allow USS a deduction for the interest, but country x may not impose tax on FSx for its receipt of interest because country x treats income of FSx as taxable directly to the owner of FSx, FPy. Country y, however, may not tax FPy on the interest because it treats the interest as income of FSx. When, as in these three cross-border examples, a U.S. taxpayer is allowed a deduction from U.S. income and there is no corresponding income inclusion in the other country, income may be taxed nowhere.

Description of Proposal

The proposal denies a deduction for interest and royalty payments made to related parties in certain circumstances described as "hybrid arrangements."

The proposal gives the following examples of situations in which a U.S. deduction is denied: A taxpayer makes an interest or royalty payment to a related party, and either (1) as a result of the hybrid arrangement, there is no corresponding inclusion to the recipient in the foreign country or (2) the hybrid arrangement permits an additional deduction for the same payment in another country.

The proposal grants the Treasury Secretary authority to prescribe regulations necessary to carry out the purposes of the proposal. These regulations might (1) deny deductions for conduit arrangements that involve a hybrid arrangement between at least two of the parties to the arrangement, (2) deny interest or royalty deductions arising from hybrid arrangements involving unrelated parties in appropriate circumstances, such as structured transactions, and (3) deny all or a portion of a deduction claimed for an interest or a royalty payment that, as a result of the hybrid arrangement, is included in the recipient's income under a preferential tax regime of the country of residence of the recipient that has the effect of reducing the country's generally applicable statutory tax rate by at least 25 percent.

[144] In this case, the country of residence of the repo buyer may treat the closure of the repo as a sale of the underlying property by the repo buyer back to the repo seller, in which case the repo buyer may have capital gain or loss for purposes of the tax laws of its country of residence. In this circumstance, it is possible that the country of residence may exempt any gain from taxation.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2014.

Analysis

Consistency with other rules and proposals

The proposal is consistent with many of the approaches to the same or similar problems taken in the Code, the OECD base erosion and profit shifting project ("BEPS"), bilateral income tax treaties, recent U.S. international tax reform proposals, and proposals or rules of other countries.

The Code includes rules that match items of income and expense, prevent the duplication of tax benefits, and hinge the allowance of a tax benefit on whether the potentially benefitted item has been subject to sufficient taxation elsewhere. As an example of a matching rule, taxpayers generally are not allowed a deduction for interest expense on indebtedness that is used to buy or hold bonds the interest on which is exempt from tax.[145] In the cross-border context, an example of anti-duplication rules are the dual consolidated loss rules.[146] Those rules are intended to prevent a U.S. taxpayer from using a loss to offset U.S. income while a foreign affiliate of the U.S. taxpayer uses the same loss to offset foreign income. A rule that hinges the allowance of a tax benefit on the imposition of taxation elsewhere is the high-tax exception from foreign base company income and insurance income under subpart F.[147] The high-tax exception from those categories of subpart F income is available only if an item of income is subject to an effective foreign income tax rate of greater than 90 percent of the maximum U.S. corporate tax rate.

The OECD BEPS project, which has a 15-point plan, has issued recommendations strikingly similar to the proposal. The OECD report on Action 2, *Neutralising the Effects of Hybrid Mismatch Arrangements* (the "OECD hybrids report"), presents the same two problems as the proposal describes: (1) payments under hybrid arrangements that are deductible in the payor's country and are not included in the income of the recipient of the payment (referred to as "deduction / no inclusion" or "D/NI" outcomes), and (2) payments under hybrid arrangements that are deductible in the payor's country and that create a duplicate deduction in another country (referred to as "double deduction" or "DD" outcomes).[148] For hybrid arrangements that yield D/NI outcomes, the OECD hybrids report recommends the same rule as the proposal: The country of residence of the payor should deny a deduction for the payment.[149] For hybrid arrangements that yield DD outcomes when payments are made by hybrid entities (which the

[145] Sec. 265(a)(2).

[146] Sec. 1503(d) and Treasury regulations thereunder.

[147] Sec. 954(b)(4).

[148] OECD hybrids report (2014), pp. 14-15

[149] *Ibid.,* pp. 36-50.

OECD hybrids report describes as the most common situation for DD outcomes), the OECD hybrids report recommends that as a "defensive rule" the country of residence of the hybrid entity making the payment should deny a deduction for the payment.[150]

U.S. bilateral income tax treaties include special rules for items of income derived through entities that are fiscally transparent under the laws of the United States or the other treaty countries. The special rule of the United States Model Income Tax Convention of November 15, 2006 (the "U.S. Model treaty"), a variant of which is included in several more recent income tax treaties and protocols, provides that an item of income derived through an entity that is fiscally transparent under the laws of either treaty country is considered derived by a resident of a treaty country to the extent the item of income is treated for purposes of the tax laws of that country as the income of a resident of that country.[151] Under this rule, if a U.S. company pays interest to an entity that is fiscally transparent under the tax laws of another treaty country, and the owners of the entity are not residents of that other country, the treaty's reduced U.S. withholding tax rate for interest is not allowed because the interest is not considered to be derived by a resident of the other treaty country. This special rule is intended to ensure that treaty benefits are available in appropriate circumstances but also to "prevent[] the use of such entities to claim treaty benefits in circumstances where the person investing through such an entity is not subject to tax on the income in its State of residence."[152] This latter goal is similar to the proposal's objective, which is to prevent the use of hybrid arrangements, such as entities that are fiscally transparent in at least one country, to produce income that is subject to tax nowhere. In the absence of the special treaty rule, the interest in the example above might benefit from a zero rate of U.S. withholding tax and may not be subject to tax in the other treaty country, because the entity receiving the interest is fiscally transparent in that country, or in the country of residence of the entity's owner, because that country may treat the entity as a separately taxable corporation.

Recent U.S. international tax reform proposals include rules similar to the proposal. For example, Senator Mike Enzi's 2012 legislation, which allows a 95-percent dividends received deduction or dividends paid by controlled foreign corporations to U.S. corporate shareholders, disallows the dividends received deduction for "hybrid dividends," dividends for which the controlled foreign corporation received a deduction or similar tax benefit in its country of residence.[153] Former Senate Finance Committee Chairman Max Baucus's staff discussion draft of a dividend exemption system includes the same rule.[154] Former Chairman Baucus's staff

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[150] *Ibid.,* pp. 51-53. The OECD hybrids report recommends that the primary response should be that the country of residence of the parent company of the hybrid entity making the payment should deny the deduction for the payment.

[151] U.S. Model treaty, Article 1, paragraph 6.

[152] United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, Article 1 (General Scope), paragraph 6, p. 5.

[153] S. 2091, 112th Cong., 2d. Sess. (2012), sec. 101(a), pp. 8-9.

[154] Chairman's Staff Discussion Draft, Option Y, sec 01(a), pp. 3-4, available at http://www.finance.senate.gov/newsroom/chairman/release/?id=f946a9f3-d296-42ad-bae4-bcf451b34b14.

discussion draft also includes a rule more directly similar to, and potentially broader than, the proposal. This rule denies a deduction for any related party payment arising from a base erosion arrangement.[155] A base erosion arrangement is any transaction that reduces the amount of foreign income tax paid and that includes, a hybrid transaction, a hybrid instrument, a hybrid entity, or one or more of certain other features.

The European Union and several countries have adopted rules intended to address hybrid arrangements. For example, this summer the Council of the European Union ("EU") adopted an amendment to the EU Parent-Subsidiary Directive requiring the country of residence of the parent company to tax payments in hybrid loan arrangements that are deductible by the payor. As examples of unilateral actions taken by various countries, Austria, France, Germany, and Mexico have adopted anti-hybrid rules into their domestic tax laws.[156]

The proposal has ample precedent in U.S. and foreign tax law, U.S. income tax treaties, recent work of the OECD, and recent U.S. tax reform proposals. It therefore does not constitute a dramatic departure. As described next, however, the proposal introduces complexities of administration.

Coordination with other provisions

The proposal would need rules for coordination with existing provisions of the Code, tax treaties, and other countries' tax laws.

The Code has provisions restricting the deductibility of some payments or otherwise disallowing certain tax benefits such as reduced withholding tax rates under tax treaties. For example, the earnings stripping rules disallow a deduction for some related party interest payments when, among other things, a corporation's debt-to-equity ratio is greater than 1.5 to 1 and its net interest expense exceeds 50 percent of its adjusted taxable income.[157] As another example, a financial institution is not allowed a deduction for the portion of its interest expense that is allocable under a pro rata formula to its tax-exempt interest income.[158] As a third example, regulations deny tax benefits for conduit financing arrangements, and these regulations include special rules permitting an entity that is disregarded for U.S. tax purposes to be treated as a separately taxable entity in determining whether a conduit financing arrangement exists.[159] Rules would need to be provided for how the proposal would interact with these existing rules. As one possibility, the proposal might apply only to the extent a deduction or another tax benefit

[155] Chairman's Staff Discussion Draft, Common Provisions, sec. 85, pp. 58-63, available at http://www.finance.senate.gov/newsroom/chairman/release/?id=f946a9f3-d296-42ad-bae4-bcf451b34b14.

[156] For descriptions of the EU amendment and the domestic law rules, see Joint Committee on Taxation, *Present Law and Background Related to Proposals to Reform the Taxation of Income of Multinational Enterprises* (JCX-90-14), July 21, 2014, pp. 56-58.

[157] Sec. 163(j).

[158] Sec. 265(b).

[159] Sec. 7701(l); Treas. Reg. sec. 1.881-3.

were not denied under one or more other Code provisions. Alternatively, the proposal might be made to apply before application of one or more other provisions disallowing deductions or other benefits.

Similar coordination would need to be considered in relation to U.S. income tax treaties. For example, one question is whether the proposal's denial of a deduction might be argued to violate the non-discrimination obligations of a treaty or the rules requiring that deductions be allowed in computing the business profits of a permanent establishment.[160] The OECD hybrids report considers this question, among other treaty coordination questions, and tentatively concludes that rules for denying deductions do not violate treaty obligations.[161] The OECD hybrids report argues, for example, that the non-discrimination obligation is not contravened simply because a rule treats payments to non-residents more restrictively than payments to residents if the rule is based on the treatment of the payments in the hands of the recipient or payor rather than based on the status of the recipient as a non-resident rather than a resident.[162] Given the differences among the many U.S. tax treaties and the many different circumstances that the proposal might affect, it is conceivable that treaty disputes might arise. It therefore might be appropriate to specify whether the proposal is intended to apply notwithstanding any treaty provision to the contrary or is intended to yield if there is an unavoidable conflict with a provision of a treaty.

A particular source of complication might be the interaction between the proposal and tax rules of other countries. For example, a country of a residence of a recipient of a payment to which the proposal applies might not tax the payment as a general matter but might include a special anti-hybrid rule that imposes taxation if the payment is deductible. In that situation a question would be whether the proposal or the tax rule of the other country should apply first. The proposal does not specify a rule coordinating application with anti-hybrid rules of other countries.

With or without a coordination rule, however, the interaction of the proposal with anti-hybrid rules of other countries would seem to raise questions of compliance and administration. If the proposal were interpreted as applying before application of another country's anti-hybrid rules, and another country's anti-hybrid rule also did not include a coordination rule, the combination of the proposal and the other country's rule could cause claims of rights to tax by both the United States and the other country or might have the consequence of requiring a taxpayer to choose whether to forgo a deduction in the United States or to include an item of income in the other country. Similarly, if instead the proposal had specified that it applied only after application of another country's anti-hybrid rule, and the anti-hybrid rule of the other country specified a similar rule of application, a taxpayer might argue that neither rule should apply or might be faced with the decision which of two rules to apply. It is unclear in these circumstances what criteria would govern the question of which country's rule should apply.

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[160] See U.S. Model treaty, Articles 7 (Business Profits) and 24 (Non-Discrimination).

[161] OECD hybrids report, pp. 93-99.

[162] *Ibid.,* p. 97.

The OECD hybrids report includes recommendations for coordinating anti-hybrid rules between payor and payee countries. For example, for D/NI outcomes, the OECD hybrids report generally recommends that the denial of a deduction in the country of residence of the payor be the primary rule and that income inclusion in the recipient's country of residence be the "defensive rule" only if the payor country does not deny a deduction.[163] Because, however, the proposal by its very nature hinges on the treatment of a payment in another country, questions of coordination are unavoidable.

On the other hand, questions of coordination with the tax laws of other countries exist under present law. For example, a foreign tax credit is allowed only for foreign income tax, and detailed rules have been promulgated to define "income tax."[164] Similarly, the credit is allowed only to the person who pays the tax, and under regulations the person who pays the tax is the person on whom foreign law imposes the legal liability for the tax.[165] Questions about whether a foreign tax is an income tax and whether a taxpayer in question is the person who has legal liability for the tax have required consideration of the tax laws of other countries. In this broad sense, to the extent the proposal requires inquiry into foreign tax law, it is not unique.

Targeted versus structural reform

The proposal is a targeted anti-abuse rule rather than structural reform. The targeted nature of the proposal raises two questions. First, to what extent will taxpayers experience the proposal as binding? Second, if the proposal encourages taxpayer avoidance, might consideration of more structural reform be appropriate?

The proposal applies only to two kinds of payments, interest and royalties, and only in defined circumstances – when payments are between related parties, there is a hybrid arrangement, *and* there is no corresponding inclusion in another country or there is a second deduction in another country. Taxpayers therefore can be expected to engage in planning to avoid application of the proposal. The proposal contemplates planning: It includes a broad grant of regulatory authority to carry out the purposes of the proposal. For example, because the proposal applies only to related party payments, taxpayers might find unrelated accommodation parties. The proposal therefore permits the Treasury Secretary to promulgate regulations denying deductions for interest and royalty payments to unrelated parties "in appropriate circumstances, such as structured transactions." A question is how the Secretary would determine criteria for which transactions are structured in a manner that triggers the proposal. Similarly, because the proposal applies when there is no corresponding income inclusion in another country, taxpayers might arrange payments to countries that impose little or specially reduced taxation. The proposal therefore permits the Secretary to promulgate regulations denying some or all of a deduction when as a result of a hybrid arrangement an interest or royalty payment is included under a preferential regime that reduces the tax rate to at least 25 percent

[163] *Ibid.*, p. 15.

[164] Treas. Reg. sec. 1.901-2.

[165] Treas. Reg. sec. 1.901-2(f).

less than the generally applicable statutory tax rate. Questions would include how it would be determined whether a particular rule is a "preferential regime" and how to measure the 25 percent reduction in relation to a particular payment. The proposal does not by its terms apply if a payment is included in income but is offset by a related deductible payment to a taxpayer in a third country. The proposal therefore gives authority to the Secretary to apply the proposal to "certain conduit arrangements." There might be difficulties in defining conduit arrangements to which the proposal would apply.

Given the back-and-forth nature of taxpayer avoidance and government response contemplated by the proposal, a question is whether structural reforms might be considered instead of or along with the proposal. Structural reform might include changes to the elective entity classification rules that have facilitated the proliferation of hybrid entities. A number of proposals to reform the entity classification rules have been made, including in the Administration's fiscal year 2011 budget proposal.[166] Consideration also might be given to broader restrictions on the deductibility of interest and other amounts. The Administration's budget proposal, for example, includes a broad restriction on the deductibility of interest paid by members of foreign-parented groups,[167] and budget proposals of both the George W. Bush administration and the Obama administration have included proposals to tighten the earnings stripping rules of section 163(j).[168] Reform of the subpart F rules might be considered. For example, the so-called CFC look-through rule of section 954(c)(6) allows an exception from subpart F income for interest, royalties, and other amounts received by one controlled foreign corporation from another controlled foreign corporation (if certain requirements are satisfied) even though the payments may be deductible in the payor country. If the recipient controlled foreign corporation is a reverse hybrid entity such that it is considered transparent in its country of residence, the payment that benefits from the CFC look-through rule also might not be taxed by the foreign country. The Administration's budget proposal includes a proposal limiting the CFC look-through rule in this circumstance.[169] The OECD BEPS project includes an action on controlled foreign corporation rules, and the OECD hybrids report recommends reform of

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[166] Department of the Treasury, General Explanation of the Administration's Fiscal Year 2010 Revenue Proposals, May 2009, "Reform Business Entity Classification Rules for Foreign Entities," p. 28. See also Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005, "Modify Entity Classification Rules to Reduce Opportunities for Tax Avoidance," pp. 182-85; Senate Finance Committee Chairman Max Baucus, Staff Discussion Draft, Common Provisions, sec. 51, "Certain entities held by controlled foreign corporations treated as corporations," pp. 24-26.

[167] See *supra,* p. 19.

[168] For three different examples of budget proposals to amend section 163(j), see Department of the Treasury, *General Explanation of the Administration's Fiscal Year 2004 Revenue Proposals,* February 2003, "Limit Related Party Interest Deductions," pp. 104-06 (among other things, applying different debt-to-asset thresholds to different categories of assets); *General Explanation of the Administration's Fiscal Year 2005 Revenue Proposals,* February 2004, "Limit Related Party Interest Deductions," p. 115 (eliminating debt-equity safe harbor, reducing adjusted taxable income threshold, reducing indefinite carryforward of disallowed interest and eliminating excess limitation carryforward); *General Explanation of the Administration's Fiscal Year 2009 Revenue Proposals,* "Limit Related Party Interest Deductions," pp. 97-98 (similar amendments applied only to inverted companies).

[169] See *infra,* p. 59.

controlled foreign corporation rules to prevent D/NI outcomes in certain arrangements involving reverse hybrids.[170] Reform of the CFC look-through rule would be a targeted, rather than structural, reform of the subpart F rules, but more thoroughgoing reform intended to reduce profit shifting broadly could be considered.

O. Limit the Application of Exceptions under Subpart F for Certain Transactions that Use Reverse Hybrids to Create Stateless Income

Present Law†

Present law combines the worldwide taxation of all U.S. persons[171] on all income, whether derived in the United States or abroad, with limited deferral for foreign income earned by foreign subsidiaries of U.S. companies, and provides territorial-based taxation of U.S.-source income of nonresident aliens and foreign entities. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax only when the income is distributed as a dividend to the domestic parent corporation. Until that repatriation, the U.S. tax on the income generally is deferred, unless the income is within certain categories of passive or highly mobile income earned by foreign corporate subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation under the controlled foreign corporation ("CFC") rules of subpart F[172] and the passive foreign investment company rules.[173] Taxation of income earned from foreign operations may differ depending upon the classification of the foreign entity conducting the foreign operations.

Entity classification rules

Many business entities, both foreign and domestic, are eligible to choose how they are classified for Federal tax purposes under the "check-the-box" regulations adopted in 1997.[174] Those regulations simplified the entity classification process for both taxpayers and the IRS, making the entity classification of unincorporated entities explicitly elective in most instances.[175]

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[170] Organisation for Economic Co-operation and Development, *Action 3 – Strengthening CFC Rules,* 2013, pp. 16-17; OECD hybrids report, pp. 47-49.

[171] Section 7701(a)(30) defines U.S. person to include all U.S. citizens and residents as well as domestic entities such as partnerships, corporations, estates, and certain trusts. Whether a noncitizen is a resident is determined under rules in section 7701(b).

[172] Secs. 951-964.

[173] Secs. 1291-1298.

[174] Treas. Reg. sec. 301.7701-1, *et seq*.

[175] The check-the-box regulations replaced Treas. Reg. sec. 301.7701-2, as in effect prior to 1997, under which the classification of unincorporated entities for Federal tax purposes was determined on the basis of a four characteristics indicative of status as a corporation: continuity of life, centralization of management, limited liability, and free transferability of interests. An entity that possessed three or more of these characteristics was treated as a corporation; if it possessed two or fewer, then it was treated as a partnership. Thus, to achieve

The eligibility of an entity to choose its classification and the array of choices in classification depend upon whether the entity is a "per se corporation" and the number of beneficial owners.

Certain entities are treated as "per se corporations" for which an election is not permitted. For domestic entities, per se corporations are generally entities formed under a State corporation statute. A number of specific types of foreign business entities are also identified in the regulations as per se corporations. Whether foreign or domestic, these per se corporations are generally entities that are not closely held and the shares of which can be traded on a securities exchange.[176]

An eligible entity with two or more members may elect to be classified as a corporation or a partnership. If an eligible entity fails to make an election, default rules apply. A domestic eligible entity with multiple members defaults to partnership treatment. A foreign eligible entity with multiple members defaults to partnership treatment, if at least one member does not have limited liability, but defaults to corporate treatment if all members have limited liability.

The regulations also provide that a single-member unincorporated entity may elect either to be treated as a corporation or to be disregarded (treated as not separate from its owner). A disregarded entity owned by an individual is treated in the same manner as a sole proprietorship. In the case of an entity owned by a corporation or partnership, the disregarded entity is treated in the same manner as a branch or division. An eligible single-member domestic entity defaults to disregarded entity status. A foreign entity with a single owner defaults to corporate status if the single owner has limited liability and to disregarded entity status if the owner does not have limited liability.

Due to differences between U.S. and foreign law, it is possible for an entity that operates cross-border to elect into a hybrid status. "Hybrid entities" are entities that are treated as flow-through or disregarded entities for U.S. tax purposes but as corporations for foreign tax purposes; for "reverse hybrid entities," the opposite is true. The existence of hybrid and reverse hybrid entities can affect whether the taxpayer can use foreign tax credits attributable to deferred foreign-source income or income that is not taxable in the United States, as well as whether income is currently includible under subpart F.

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characterization as a partnership under this system, taxpayers needed to arrange the governing instruments of an entity in such a way as to eliminate two of these corporate characteristics. The advent and proliferation of limited liability companies ("LLCs") under State laws allowed business owners to create customized entities that possessed a critical common feature—limited liability for investors—as well as other corporate characteristics the owners found desirable. As a consequence, classification was effectively elective for well-advised taxpayers.

[176] For domestic entities, the State corporation statute must describe the entity as a corporation, joint-stock company, or in similar terms. The regulations also treat insurance companies, organizations that conduct certain banking activities, organizations wholly owned by a State, and organizations that are taxable as corporations under other Code provisions as per se corporations.

Subpart F and exceptions

Under subpart F, a CFC generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).[177] The United States generally taxes the 10-percent U.S. shareholders of a CFC on their pro rata shares of certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.[178] In effect, the United States treats the 10-percent U.S. shareholders of a CFC as having received a current distribution of the corporation's subpart F income. Subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another and consists of foreign base company income,[179] insurance income,[180] and certain income relating to international boycotts and other violations of public policy.[181]

A provision of law colloquially referred to as the "CFC look-through" rule excludes from foreign personal holding company income dividends, interest, rents, and royalties received or accrued by one CFC from a related CFC (with relation based on control) to the extent attributable or properly allocable to non-subpart-F income of the payor.[182] The CFC look-through rule has sunset, and remains applicable only for taxable years of the CFC beginning after 2004 and before 2014, and the taxable years of the U.S. shareholders with or within which such taxable years of the CFC ends.[183]

There is also an exception colloquially referred to as the same-country exception. First, dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized may be excluded from subpart F income. In addition, rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is organized are not included in subpart F income.[184] The same-country exception is not available to the extent that the payments reduce the subpart F income of the payor.

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[177] Secs. 951(b), 957, and 958.

[178] Sec. 951(a).

[179] Sec. 954. Foreign base company income consists of foreign personal holding company income, which includes passive income such as dividends, interest, rents, and royalties, and a number of categories of income from business operations, including foreign base company sales income, foreign base company services income, and foreign base company oil-related income.

[180] Sec. 953.

[181] Sec. 952(a)(3)-(5).

[182] Sec. 954(c)(6).

[183] Sec. 954(c)(6)(C). American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, sec. 323(a).

[184] Sec. 954(c)(3).

Two additional exceptions to subpart F focus on foreign tax burden and principles as elements relevant to deferral. First, certain income of a CFC that is derived in the active conduct of banking or financing business ("active financing income") is also excepted from subpart F.[185] With respect to income derived in the active conduct of banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the active financing exceptions. Second, an exception from foreign base company income and insurance income is also available for any item of income received by a CFC if the taxpayer establishes that the income was subject to an effective foreign income tax rate greater than 90 percent of the maximum U.S. corporate income tax rate (that is, more than 90 percent of 35 percent, or 31.5 percent).[186]

Description of Proposal

Under the proposal, neither the same-country exception nor the CFC look-through treatment exception to Subpart F is applicable to payments that a foreign reverse hybrid receives from a foreign related person if the hybrid is held directly by a U.S. owner and the payments are treated as deductible payments from a related foreign person.[187]

Effective date.−The proposal is effective for taxable years beginning after December 31, 2014.

Analysis

This proposal is the second of two proposals by which the Administration addresses what it terms a "proliferation of tax avoidance techniques involving a variety of cross-border hybrid arrangements."[188] Both of the Administration's proposals on hybrid arrangements are limited to transactions between or among related parties. Both proposals would address mismatches involving use of hybrid entities, but the first proposal is the broader of the two and targets asymmetrical or mismatched tax effects that are generated by hybrid arrangements among related parties, whether achieved by use of hybrid entities, hybrid instruments, hybrid transfers (such as sales-repurchases) or other hybrid arrangements. In contrast, this proposal specifically targets the potential double nontaxation that may result when a CFC is a reverse hybrid. A reverse

[185] Sec. 954(h). This exception now applies only to taxable years of foreign corporations starting before January 1, 2014 (and to taxable years of 10-percent U.S. shareholders with or within which those corporate taxable years end), under an extension of this provision in 2013. American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, sec. 322(b).

[186] Sec. 954(b)(4).

[187] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item V.O., reprinted in the back of this volume.

[188] See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals*, March 2014, pages 61 and 62, under "Reasons for Change." The other proposal, "Restrict the Use of Hybrid Arrangements that Create Stateless Income," page 61, is described above at part V.N.

hybrid is an entity that is fiscally transparent for foreign tax purposes but taxable as a corporation for U.S. tax purposes.

The perceived abuse targeted by the proposal is the apparent reduction of foreign taxes that can be achieved with a reverse hybrid and the exceptions to the subpart F rules, as demonstrated in this example. Consider a U.S. controlled group, in which a U.S. company wholly owns CFC1, formed and resident in Country X, and serving as a holding company for offshore operations of the group. CFC1 in turn owns two operating subsidiaries, CFC2 in Country X and CFC3 in Country Y and receives dividends and interest from both. Under subpart F, payments to CFC1 by CFC2 are generally not includible in the subpart F income of CFC1 and enjoy deferral due to the same country exception. The payments from CFC3 to CFC1 are also likely to be eligible for continued deferral by reason of the CFC look-through exception. Deferral is unavailable only if the payments to CFC1 reduce the subpart F income of the payor. Assume that Country X requires inclusion of the payments in CFC1 income, and allows deductions by CFC2 for the payments. The tax treatment of the payments is symmetrical - there is both an inclusion by the recipient and a deduction by the payor. If CFC1 were replaced by a reverse hybrid, the symmetrical treatment of payments from the lower tier subsidiaries is broken. Although CFC1 continues to be treated as a corporation for U.S. tax purposes, with continued deferral of income received from its subsidiaries, CFC1 is now fiscally transparent to Country X. Accordingly, the payments received by CFC1 from CFC2 and CFC3 are viewed by Country X as payments made directly to the U.S. parent and are not subject to Country X tax. CFC2 and CFC3 continue to be entitled to deduct the payments in computing income for foreign tax purposes.

The proposal responds to the resulting double nontaxation by denying the subpart F exceptions that permit the income to avoid U.S. tax. The limited nature of the proposal prompts the questions of whether the proposal is appropriately targeted, and whether alternative proposals and factors merit consideration, as discussed below.

Whether the proposal appropriately targets the perceived abuse

In analyzing whether the proposal is appropriately crafted, it is helpful to consider the policies that are implicated in the targeted transaction and the extent to which taxpayers may alter their behavior or restructure in response to the proposal. Although critics of the look-through exception and check-the-box rules have described that exception as an "endorsement" of subpart F planning using hybrids,[189] the purpose of the look-through rule as explained in its legislative history is to allow U.S. multinational companies to redeploy their active foreign earnings overseas with no additional U.S. tax burden, thereby making U.S. businesses and U.S. workers more competitive with businesses based in other countries, many of which grant a similar benefit to their companies.[190] The rule thus may operate to eliminate distortion in deciding where to invest, and permit movement of foreign earnings from one CFC to another

[189] Kenan Mullis, "Check-the-Box and Hybrids: A Second Look at Elective U.S. Tax Classification for Foreign Entities," *Tax Analysts* October 31, 2011, p. 371.

[190] See H.R. Rep. No. 109-304, (2005) at 45.

CFC more efficiently. The policy underlying the same-country exception also may be, in part, the efficient use of resources, but it should be noted that the same-country exception does not bear the same risk of double nontaxation as that of the CFC look-through rules, because most countries would tax income arising from the economic activities within its own borders. By denying the benefits of the exceptions to the subpart F rules in cases in which only the tax of a foreign jurisdiction has been reduced, the proposal may be inconsistent with the policies underlying these exceptions.

On the other hand, supporters of the proposal may note that it is debatable whether one can say that only the foreign tax base is harmed. To the extent that the subpart F exceptions increase opportunities to achieve double nontaxation, the expected tax savings from the reduced foreign taxes may lead to tax-motivated investments that would otherwise be inefficient. In targeting a mismatch that on its face appears to harm only the foreign jurisdiction and not the United States, the proposal is consistent with the recommendations of the OECD on how to neutralize the hybrid mismatches, as discussed below.

Concern about the use of hybrid entities in tax avoidance techniques is neither new nor unique to the United States, as the prominence of the issue in the BEPS project demonstrates, and the OECD Hybrid Mismatch Report makes clear. In that report,[191] the OECD identifies the problem in terms of double nontaxation that reduces the collective tax base, and proposes that efforts focus on neutralizing the asymmetrical outcome rather than identifying the jurisdiction in which the tax benefit arises. It defines a hybrid mismatch arrangement as one that "exploits a difference in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to produce a mismatch in tax outcomes where that mismatch has the effect of lowering the aggregate tax burden of the parties to the arrangement."[192] The recommendations of the OECD include several specific measures to address the undesirable mismatches, including specific changes to domestic law that countries may adopt unilaterally to target mismatch arrangements involving reverse hybrids. The OECD recommends that investor jurisdictions adopt or strengthen anti-deferral rules to preclude the double nontaxation achieved by reverse hybrids.[193] The Administration proposal is consistent with these principles, as a unilateral action intended to reduce incentive to structure actions that erode the collective tax base, even though the U.S. tax base may not be directly affected by the targeted structure.

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[191] The issues to be addressed in 2014 and 2015 were identified in OECD, *Action Plan on Base Erosion and Profit Shifting*, 2013. Available at http://dx.doi.org/10.1787/9789264202719-en. The deliverable on hybrid arrangements is *Neutralising the Effects of Hybrid Mismatch Arrangements*, September 16, 2014, available at http://dx.doi.org/10.1787/9789264218819-en (the "Hybrid Mismatch Report").

In paragraph 13 of a communiqué issued at the conclusion of its conference November 15 and 16, 2014 in Brisbane, Australia, the G-20 nations committed to finalizing the work of the BEPS project in 2015. Available at https://www.g20.org/sites/default/files/g20_resources/library/brisbane_g20_leaders_summit_communique.pdf

[192] The Hybrid Mismatch Report at para. 41.

[193] See Recommendation 5, and discussion at paragraphs 87 and 88 in the Hybrid Mismatch Report.

Because the proposal is limited to reverse hybrids that are owned directly by a U.S. parent, the proposal may be unnecessarily narrow. Double nontaxation or other asymmetrical results could be achieved by placing the hybrid entity at a lower tier in the structure, or by using a simple hybrid in other earnings stripping transactions.[194] To the extent that the double nontaxation is not dependent on operation of subpart F rules, the proposal is of no effect. It may be that this proposal should be considered as a necessary part of the other, broader proposal that addresses hybrid arrangements, because its value as a standalone proposal is limited.

Additional factors or alternative remedies to consider

In the United States, there are two features of present law subpart F that, in combination with a hybrid entity, can facilitate avoidance of the anti-deferral rules or increase available foreign tax credits — the CFC look-through rule and the same-country exception.[195] The proposal addresses the subpart F exceptions of present law but is silent as to the ease with which a hybrid can be created, despite the fact that the interaction of the entity classification rules and subpart F has previously been the subject of concern.[196] An earlier proposal in the President's Budget for fiscal year 2010 limited the entity classification rules significantly but was not included in subsequent budget proposals.[197] Former Senate Finance Committee Chairman Max Baucus offered international and business tax reform proposals that included repeal of the entity classification rules in certain cross-border scenarios.[198] Non-governmental organizations have called for repeal of check-the-box[199] as well as CFC look-through rules.[200]

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[194] Several examples of transactions that may achieve unintended tax savings by use of hybrid entities are described in the following articles: Kenan Mullis, "Check-the-Box and Hybrids: A Second Look at Elective U.S. Tax Classification for Foreign Entities," *Tax Analysts* October 31, 2011, p. 371; Diane M. Ring, "One National Among Many: Policy Implications of Cross-border Tax Arbitrage," 44 Boston College Law Review 79 (2002), http://lawdigitalcommons.bc.edu/bclr/vol44/iss1/2.

[195] As noted above, the CFC look-through rule has sunset. See section 954(c)(6)(C).

[196] Notice 98-11, 1998-1 C.B. 433 (announcing intention to limit use of hybrid branches or other entities to circumvent subpart F), *withdrawn*, Notice 98-35, 1998-2 C.B. 34. See, *e.g.*, Cynthia Ram Sweitzer, "Analyzing Subpart F in Light of Check-the-Box," 20 *Akron Tax Journal 5* (2005).

[197] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals*, p. 28, May 2009. A full discussion of the proposal is included in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal; Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment* (JCS-4-09), September 2009.

[198] Chairman Baucus's staff discussion draft, Nov. 19, 2013, available at http://www.finance.senate.gov/newsroom/chairman/release/?id=f946a9f3-d296-42ad-bae4-bcf451b34b14.

[199] See Mark Boyd, "Check the Box: The $10 Billion Tax Loophole," Center for Effective Government Blog: The Fine Print, February 20, 2014. Available at http://www.foreffectivegov.org/blog/check-box-10-billion-tax-loophole.

[200] See report by Citizens for Tax Justice, "Don't Renew the Offshore Tax Loopholes," August 2, 2012. http://ctj.org/ctjreports/2012/08/dont_renew_the_offshore_tax_loopholes.php.

Interaction of entity classification and subpart F

In Notice 98-11, the IRS and Treasury Department announced that they had become aware of the increased use of certain transactions that utilized "hybrid branches" to circumvent the purposes of subpart F.[201] The notice defined a hybrid branch as an entity with a single owner that is treated as a separate entity under the relevant tax laws of a foreign country and as a branch (i.e., disregarded entity) of a CFC that is its sole owner for U.S. tax purposes. In each of the transactions described in the notice, a taxpayer utilized a hybrid branch arrangement to make deductible interest payments that reduced the CFC's foreign tax liability, and created low-taxed interest income in another entity, without creating subpart F income. Notice 98-11 describes these transactions as inconsistent with one purpose of subpart F, to prevent CFCs (including those engaged in active business) from structuring transactions designed to manipulate the inconsistencies between foreign tax systems to generate inappropriately low- or non-taxed income on which U.S. tax might be permanently deferred.

The remedy in this proposal may be criticized as too narrow because it does not address the entity classification rules. Those rules permit creation of structures that achieve the same tax consequences as those achieved under the look-through rule or same-country exception. The rationale for permitting an entity to select its own entity classification is generally premised on simplicity, which critics contend is counterbalanced by the risk of asymmetry in the cross-border context. Nevertheless, because the classification rules have now been in place for close to 20 years, supporters of the proposal may argue that broader changes to the ability to create hybrids through use of the check-the-box rules is more appropriately considered in the context of comprehensive reform. In their view, the immediate concern is not the structure, but the resulting mismatch, and to the extent that the proposal can target means of correcting the mismatch, that is sufficient.

Further detail needed

Several additional elements may need to be considered if the proposal is adopted, affecting both the scope and specificity of the proposal as well as ease of administration. The OECD in its report outlined principles requiring that any proposed remedy should be comprehensive, capable of automatic application without resulting in double taxation or undue disruption under existing domestic law; be designed and implemented in a manner that is clear and transparent; and minimize compliance costs for taxpayers and additional administrative burdens on tax authorities.[202]

First, it is not clear how broad the disallowance is. In referring to payments from related parties, the proposal is framed in terms similar to the general provisions of subpart F describing the treatment of items of income. However, any particular stream of payments may be included or excluded from subpart F for a number of reasons. An ordering rule may be needed to determine whether or not the nontaxation of a payment flow is the result of the subpart F

[201] Notice 98-11, 1998-1 C.B. 433, *withdrawn*, Notice 98-35, 1998-2 C.B. 34.

[202] Paragraph 11, Hybrid Mismatch Report.

exceptions that are the subject of the proposal, or arises from another provision. Should a presumption be invoked if any payments are subjected to the proposal, such that the subpart F exceptions will be unavailable for that reverse hybrid in all future years for payments from the related party? Instead of turning off the subpart F exception with respect to one stream of payments, it may be preferable to disallow the look-through rule or same-country exception with respect to any activity of the reverse hybrid.

Critics may also note that the proposal is silent with respect to any measure intended to ameliorate administrative burdens, whether for taxpayers or tax officials. In contrast, the Hybrid Mismatch Report included specific recommendations about the need for information reporting and exchange of information, and possible transition rules. Toward that end, the recommendations include guidelines on how to ensure that jurisdictions share information needed to analyze hybrid arrangements and coordinate the implementation. Supporters may counter that the lack of mention of administrative issues is inconsequential, in that broader improvements of information reporting and exchange of information are contemplated by other proposals that are not limited to hybrid mismatches.[203]

P. Limit the Ability of Domestic Entities to Expatriate

Present Law

The U.S. tax treatment of a multinational corporate group depends significantly on whether the parent corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the laws of the United States or of any State.[204] All other corporations (that is, those incorporated under the laws of foreign countries) are treated as foreign.[205] Thus, place of incorporation determines whether a corporation is treated as domestic or foreign for purposes of U.S. tax law, irrespective of substantive factors that might be thought to bear on a corporation's residence, considerations such as the location of the corporation's management activities, employees, business assets, operations, or revenue sources; the exchange or exchanges on which the corporation's stock is traded; or the country or countries of residence of the corporation's owners. Only domestic corporations are subject to U.S. tax on a worldwide basis. Foreign corporations are taxed only on income that has a sufficient connection with the United States.

To the extent the U.S. tax rules impose a greater burden on a domestic multinational corporation than on a similarly situated foreign multinational corporation, the domestic multinational company may have an incentive to undertake a restructuring, merger, or acquisition that has the consequence of replacing the domestic parent company of the multinational group with a foreign parent company. This sort of transaction, in which a foreign

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[203] See Parts XVII.A.4 and XVII.A.5, herein, for discussion of proposals intended to expand information reporting.

[204] Sec. 7701(a)(4).

[205] Sec. 7701(a)(5).

corporation replaces a domestic corporation as the parent company of a multinational group, has been commonly referred to as an inversion. Subject to the Code's anti-inversion rules (described below) and other provisions related to, for example, outbound transfers of stock and property, the deductibility of related party interest payments, and a foreign subsidiary's investment in U.S. property, an inversion transaction might be motivated by various tax considerations, including the removal of a group's foreign operations from the U.S. taxing jurisdiction and the potential for reduction of U.S. tax on U.S.-source income through, for example, large payments of deductible interest or royalties from a U.S. subsidiary to the new foreign parent company.

Until enactment of the American Jobs Creation Act of 2004 ("AJCA"),[206] the Code included no rules specifically addressed to inversion transactions. Consequently, until AJCA a domestic corporation could re-domicile in another country with insignificant or no adverse U.S. tax consequences to the corporation or its shareholders even if nothing related to the ownership, management, or operations of the corporation changed in connection with the re-domiciliation.[207]

AJCA included provisions intended to curtail inversion transactions. Among other things, the general anti-inversion rules (the "toll charge rules") provide that during the 10-year period following the inversion transaction corporate-level gain recognized in connection with the inversion generally may not be offset by tax attributes such as net operating losses or foreign tax credits. These sanctions generally apply to a transaction in which, pursuant to a plan or a series of related transactions: (1) a domestic corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after March 4, 2003; (2) the former shareholders of the domestic corporation hold (by reason of the stock they had held in the domestic corporation) at least 60 percent but less than 80 percent (by vote or value) of the stock of the foreign-incorporated entity after the transaction (this stock often being referred to as "stock held by reason of"); and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (that is, the "expanded affiliated group"), does not have

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[206] Pub. L. No. 108-357.

[207] Shareholders of the re-domiciled parent company who were U.S. persons generally would be subject to U.S. tax on the appreciation in the value of their stock of the U.S. company unless a number of conditions were satisfied, including that U.S. persons who were shareholders of the U.S. company received 50 percent or less of the total voting power and total value of the stock of the new foreign parent company in the transaction. See section 367(a)(1); Treas. Reg. sec. 1.367(a)-3(c)(1). The IRS promulgated these greater-than-50-percent rles after becoming aware of tax-motivated inversion transactions, including the publicly traded Helen of Troy cosmetic company's re-domiciliation in Bermuda. See Notice 94-46, 1994-1 C.B. 356 (April 18, 1994); T.D. 8638 (December 26, 1995). Shareholder taxation under section 367 as a result of inversion transactions remains largely the same after enactment of AJCA.

If an inversion transaction was effectuated by means of an asset acquisition, corporate-level gain generally would have been recognized under section 367(a).

For a fuller description of the possible tax consequences of a reincorporation transaction before AJCA, see Joint Committee on Taxation, *Background and Description of Present-Law Rules and Proposals Relating to Corporate Inversion Transactions* (JCX-52-02), June 5, 2002, p. 4.

substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group.[208]

If a transaction otherwise satisfies the requirements for applicability of the anti-inversion rules and the former shareholders of the domestic corporation hold (by reason of the stock they had held in the domestic corporation) at least 80 percent (by vote or value) of the stock of the foreign-incorporated entity after the transaction, the anti-inversion rules entirely deny the tax benefits of the inversion transaction by deeming the new top-tier foreign corporation to be a domestic corporation for all Federal tax purposes.[209]

Similar rules apply if a foreign corporation acquires substantially all of the properties constituting a trade or business of a domestic partnership.[210]

The Treasury Department has promulgated detailed guidance under section 7874. Most recently, the IRS and Treasury Department issued a notice intended to address avoidance of section 7874 and to restrict or eliminate certain tax benefits facilitated by inversion transactions.[211]

Description of Proposal

Historic ownership test

The proposal eliminates the toll charge rules for transactions in which historic shareholders of the expatriated entity own at least 60 percent but less than 80 percent of the stock of the new foreign-incorporated entity.

The proposal reduces the historic stock ownership threshold at which the new foreign-incorporated entity is treated for purposes of the Code as a domestic corporation from 80-percent historic ownership to more than 50-percent historic ownership.

Consequently, if, in a transaction that otherwise satisfies the present law requirements for applicability of the anti-inversion rules, the historic shareholders of the former domestic

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[208] Section 7874(a). AJCA also imposes an excise tax on certain stock compensation of some executives of companies that undertake inversion transactions. Section 4985.

[209] Sec. 7874(b).

[210] Sec. 7874(a)(2)(B)(i).

[211] Notice 2014-52, 2014 I.R.B. LEXIS 576 (Sept. 22, 2014). Among other things, the notice describes regulations that the Treasury Department and IRS intend to issue (1) addressing some taxpayer planning to keep the percentage of the new foreign parent company stock that is held by former owners of the inverted domestic parent company (by reason of owning stock of the domestic parent) below the 80 or 60 percent threshold; (2) restricting the tax-free post-inversion use of untaxed foreign subsidiary earnings to make loans to or stock purchases from certain foreign affiliates, and (3) preventing taxpayers from avoiding U.S. taxation of pre-inversion earnings of foreign subsidiaries by engaging in post-inversion transactions that would end the controlled foreign corporation status of those subsidiaries.

corporation own more than 50 percent of the stock (by vote or value) of the new foreign-incorporated entity, the new foreign-incorporated entity is considered a domestic corporation for all purposes of the Code.

New U.S. management and control and substantial business activities test

The proposal provides that, if a transaction satisfies the requirements for applicability of the anti-inversion rules except for the 50-percent historic ownership test, the new foreign-incorporated entity is treated as a domestic corporation for all purposes of the Code if the expanded affiliated group that includes the new foreign corporation has substantial business activities in the United States and the foreign corporation is primarily managed and controlled in the United States.

New partnership rule

The proposal provides that the anti-inversion rules apply when a foreign corporation acquires, in a transaction that otherwise satisfies the requirements for applicability of the rules, substantially all of the assets of a domestic partnership, whether or not the assets constitute a trade or business. Under present law, a foreign corporation's acquisition of a domestic partnership triggers the anti-inversion rules only if the acquisition is of substantially all of the properties constituting a trade or business of the partnership.

Effective date.−The proposal is effective for transactions completed after December 31, 2014.

Analysis

Identifying the U.S. tax policy objective

The proposal may have the effect of discouraging some cross-border mergers and acquisitions and therefore raises the question of what should be the objectives of U.S. tax rules related to cross-border transactions.

The proposal implicates cross-border mergers and acquisitions, not mere re-domiciliations of existing companies, because if a domestic corporation does nothing more than change its place of organization to a foreign country, present law generally ignores the re-domiciliation and treats the purportedly foreign corporation as a domestic corporation for all purposes of the Code.[212] A domestic corporation seeking to redomicile in a country in which it will not have substantial business activities after the redomiciliation instead generally must undertake a transaction such as a cross-border merger or acquisition that produces a change of

[212] Present law respects the foreign status of the newly foreign corporation if the group of which the corporation is a member has substantial business activities in the corporation's country of organization.

ownership such that more than 20 percent of the stock of the new foreign parent company is owned by persons who were not shareholders of the former domestic parent company.[213]

The proposal's stated objective is to protect the U.S. tax base. The proposal's "Reasons for Change" include the following statement: "Inversion transactions raise significant policy concerns because they facilitate the erosion of the U.S. tax base. . . ."[214]

Protecting the U.S. tax base may be in tension with other possible policy goals related to cross-border mergers and acquisitions. One tax policy goal might be complete neutrality toward cross-border transactions – in other words, that the U.S. tax rules would have no effect on cross-border transactions. Given the complexities of cross-border business activities and the variations among tax systems of countries around the world, achieving full U.S. tax neutrality toward cross-border transactions is likely not realistic.

A related goal is minimizing the extent to which the U.S. tax rules affect cross-border transactions in a way that reduces investment or employment in the United States. In the context of inversions, a question related to this goal is whether inversions targeted by the proposal have adverse effects on economic activity in the United States. If, as one possibility, inversions meaningfully reduce economic activity in the country of residence of the inverting company because, for example, the location of a multinational company's tax residence is positively correlated with the location of its capital and labor, and if the proposal reduces the frequency of inversions, the proposal might have the effect of keeping economic activity in the United States. As a contrasting possibility, if cross-border acquisitions involving U.S. companies have the overall effect of increasing rather than decreasing investment and employment in the United States, by, for example, allowing the more efficient allocation of capital and labor across borders, then the proposal might have a negative effect on U.S. economic activity if it reduces the volume of cross-border acquisitions. An article surveying the relevant literature and describing case studies involving recent inversions concludes that the effects of inversions on meaningful economic activity in the initial home country of the inverting company are uncertain and are dependent on the particular circumstances of the relevant companies.[215]

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[213] Sec. 7874(b) (the 80-percent ownership test described previously).

[214] Department of the Treasury, *General Explanations of the Administration's Fiscal year 2015 Revenue Proposals,* March 2014, p. 64. The staff of the Joint Committee on Taxation's estimate of the proposal is that it will raise revenue by $17.3 billion in the 10-year period from 2015 through 2024. Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, p. 3. Based on more recent work related to possible inversion transactions under present law, the staff of the Joint Committee on Taxation has estimated that a bill introduced by Representative Levin, the Stop Corporate Inversions Act, H.R. 4679, 113th Cong., 2d Sess. (2014), similar in substance to the proposal, would raise $33.6 billion in the 10-year period from 2015 through 2024. See U.S. House of Representatives Committee on Ways and Means Democrats, "JCT: Inversion Legislation Could Save $33 Billion in Tax Revenue," available at http://democrats.waysandmeans.house.gov/press-release/jct-inversion-legislation-could-save-33-billion-tax-revenue.

[215] Omri Marian, "Home-Country Effects of Corporate Inversions," *Washington Law Review,* vol. 90, 2015 (forthcoming).

The proposal's treatment of a post-acquisition foreign parent company as a domestic corporation if the company is primarily managed and controlled in the United States and the worldwide group has substantial business activities in the United States raises the question whether companies undertaking cross-border acquisitions involving U.S. companies would respond to the proposal by moving senior managers and executive officers, employees, or tangible capital outside the United States. If the proposal had this effect, the proposal might be criticized as protecting the U.S. corporate tax base at the expense of encouraging investment and employment in the United States. It may, however, be difficult to test this question.

Identifying the objectionable transaction

The proposal raises the question of what sort of cross-border mergers and acquisitions other than those already subject to the present law anti-inversion rules should be considered objectionable as a matter of U.S. tax policy.

Present law has two main criteria for whether U.S. shareholder and corporate taxation is imposed in connection with a transaction in which a foreign corporation replaces a domestic entity as the parent entity of an enterprise. One criterion is whether a threshold percentage of the stock of the new foreign parent corporation is owned by shareholders of the former domestic parent corporation. This criterion, in turn, has two variations. U.S. persons who transfer stock of a domestic corporation to a foreign corporation and receive in exchange stock of the foreign corporation are generally subject to U.S. taxation on the appreciation in value of their stock of the domestic corporation unless, among other requirements, 50 percent or less of the total voting power and total value of the stock of the foreign corporation is received by U.S. persons who transferred stock of the domestic corporation in exchange for stock of the foreign corporation.[216] In this first variation, identity of ownership of the former domestic parent corporation and the new foreign parent corporation matters to the extent the historic owners of the domestic corporation are themselves U.S. persons. The more recently enacted anti-inversion rules of section 7874 generally impose tax on the inversion gain of an expatriated corporation if, among other conditions, at least 60 percent and less than 80 percent of the stock of the new foreign corporation is owned by former shareholders of the domestic corporation by reason of their ownership of stock of the domestic corporation. If 80 percent or more of the stock of the new foreign corporation is owned by former shareholders of the domestic corporation, the anti-inversion rules treat the new foreign corporation as domestic for all purposes of the Code. In this second variation of the first criterion, unlike in the first variation, the foreign or domestic residence of the shareholders in question is irrelevant; what matters is whether at least 60 percent or 80 percent of the stock of the new foreign parent company is owned by former shareholders of the former domestic parent company, whether those shareholders are U.S. or foreign persons.

[216] Treas. Reg. sec. 1.367(a)-3(c)(1). These regulations were preceded by a notice that included the same 50-percent historic ownership rule and that was effective for transfers after April 18, 1994. Notice 94-46, 1994-1 C.B. 356 (Jan. 1994). This notice was prompted by concern over, among other activities, the transaction in which a newly formed Bermuda corporation became the parent company of Helen of Troy, a publicly traded U.S. cosmetics company. For a brief history of inversions, and legislative and regulatory responses, including issuance of Notice 94-46 and the subsequent regulations under section 367(a), see Mindy Herzfeld, "What's Next in Inversion Land?" *Tax Notes,* June 16, 2014, p. 1225.

A second criterion for whether U.S. taxation is imposed in connection with a transaction is the location of business activities of the enterprise in question. The section 7874 anti-inversion rules do not apply if the expanded affiliated group of which the new foreign parent corporation is a member has substantial business activities in the country of organization of the new foreign corporation when compared with the total business activities of the expanded affiliated group.[217]

The two present law criteria for whether U.S. taxation is imposed in connection with targeted transactions are based on substantive characteristics of the business in question, the extent of common ownership of the former domestic parent corporation and the new foreign parent corporation and the location of the business activities of the group. The Administration's budget proposal uses the same two substantive considerations in modified form. For the first consideration, the extent of common ownership of a parent corporation before and after a transaction, the proposal eliminates the toll charge rules when common ownership is at least 60 percent and less than 80 percent and instead treats the new foreign parent corporation as domestic for all purposes of the Code if the owners of the former domestic parent corporation own more than 50 percent of the stock of the new foreign parent corporation. For the second consideration, the location of the business activities of a corporate group, the proposal keeps present law's exception when a group has substantial business activities in the country of organization of the new foreign parent corporation, and it adds a new rule, described below, when a group has substantial business activities in the United States.

The proposal also adds a third substantive criterion, whether a group is primarily managed and controlled in the United States. In particular, in a situation in which the proposal's more-than-50-percent historic ownership threshold is not satisfied, the proposal treats a new foreign parent corporation as domestic for all Code purposes if the group that includes the foreign corporation has substantial business activities in the United States and is primarily managed and controlled in the United States.[218]

One question is whether the proposal's substantive considerations – extent of identity of ownership (by U.S. persons or foreign persons) of the former domestic parent corporation and the new foreign parent corporation; the location of the business activities of the group that includes the new foreign parent corporation; and the location of the group's primary management and control – are the most appropriate considerations for determining the residence of a new foreign parent corporation that would otherwise be treated as foreign under the general U.S. rule for residence of a corporation, place of incorporation.[219] For example, it might be argued that if a reason to impose income taxation on a corporation is to ensure that owners of the corporation are taxed on their shares of corporate income, the best direct criterion for whether a

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[217] Section 7874(a)(2)(B)(iii). A taxpayer can qualify for this substantial business activities exception only if at least 25 percent of group employees, compensation, assets, and income is based in the country of organization of the foreign parent corporation. Temp. Treas. Reg. sec. 1.7874-3T(b).

[218] The proposal does not treat the new foreign parent corporation as domestic if the present law exception for substantial business activities in the country of residence of the new foreign parent corporation is satisfied.

[219] Sec. 7701(a)(4).

new foreign parent corporation should be treated as domestic is, as under section 367(a), the extent to which the owners of the new foreign parent corporation are themselves U.S. persons.[220]

If identity of ownership of the former domestic parent corporation and the new foreign parent corporation is an appropriate criterion for determining the residence of a new foreign parent corporation, a second question is at what level of common ownership the new foreign parent corporation should be considered domestic for all U.S. tax purposes. Present law requires at least 80 percent common ownership. The proposal reduces the threshold to more than 50 percent. If a bigger U.S. company merges with a smaller foreign company in an all-stock transaction, the proposal treats the parent company of the combined group as domestic (unless the group satisfies the substantial business activities exception). In contrast with the present law 80-percent threshold, which applies only when the foreign company engaging in the transaction is no more than one-quarter the size of its domestic merger partner, the greater-than-50-percent rule could create adverse tax consequences for mergers of relative equals, mergers that typically are thought of as having significant non-tax business motivations (even if they also have underlying tax considerations). For example, when Belgian brewer InBev acquired U.S. brewer Anheuser-Busch in 2008, the acquisition created the world's largest brewing company, and the transaction was touted as creating a globally diversified company with an extensive distribution network and high potential for growth.[221] The combined company, AB InBev, is resident for tax purposes in Belgium. Had the acquisition been structured as an all-stock transaction, it might have run afoul of the proposal, and the new parent company thereby would have been treated as a U.S. corporation for all Code purposes, because the equity value of Anheuser-Busch set by the acquisition price was greater than the market capitalization of InBev in the year of the acquisition.[222] Views about whether AB InBev should be treated as a domestic corporation for U.S. tax purposes, and, more broadly, whether the United States should as a general matter treat the parent company resulting from a cross-border merger between a U.S. company and a similarly sized foreign company as a domestic corporation, should inform consideration whether the proposal's 50-percent ownership threshold is appropriate.

A third question is, if the location of a group's primary management and control is an appropriate measure of whether a purportedly foreign corporation should be treated as domestic for all Code purposes, why that management-and-control test should apply only when a domestic corporation has been replaced by a foreign corporation as the parent company of a worldwide group of companies. Consider two worldwide groups of companies that both have foreign corporations as their parent companies and both of which have substantial business activities in

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[220] Compare Michael Graetz, "The Bipartisan 'Inversion' Evasion," *Wall Street Journal,* September 25, 2014, p. A13 (arguing, "[A]t a minimum, serious tax reform should shift taxes from corporations to their shareholders and bondholders.")

[221] See AB InBev press release, November 18, 2008, http://www.ab-inbev.com/press_releases/20081118_1_e.pdf.

[222] The acquisition price set the equity value of Anheuser-Busch at $52.2 billion. See PowerPoint presentation used for InBev Analyst Meeting, October 2008, http://www.ab-inbev.com/pdf/InBev_Analyst_Meeting_Oct_2008.pdf, slide 18; Ab InBev, Our Key Figures, http://www.ab-inbev.com/go/investors/financial_information/our_key_figures.cfm.

the United States and are primarily managed and controlled in the United States. Assume that in the first worldwide group the foreign parent corporation has replaced a domestic corporation as the parent company of the group, perhaps in connection with a merger between a larger (or smaller) foreign company and a smaller (or larger) domestic company. Assume that in the second worldwide group of companies the parent company was a foreign corporation – because it was organized under the laws of a foreign country – from the start of the group's business operations. Suppose that the companies are otherwise similar in their activities and in the location of their tangible property, employees, and customers; they are close competitors of one another. The proposal treats the foreign parent company as domestic only for the first group of companies – when a foreign corporation replaced a domestic corporation as the parent of the group – not for the second group of companies, where the group's parent company was foreign from the outset.

It is unclear as a conceptual matter why the otherwise similar hypothetical competitors just described should be taxed fundamentally differently from one another only because at some point in the first company's history, there was a cross-border transaction after which the parent company was foreign. A more practical criticism is that the management-and-control test for multinational groups that result from cross-border acquisitions could have unintended consequences. For example, it might create an incentive to start a new business as a foreign rather than domestic company so that possible future business combinations with foreign companies would not be hindered by the concern that the U.S. tax rules would treat the parent company of the combined group as domestic. Alternatively, the management-and-control test might create a tax incentive for multinational businesses to locate senior managers and other officers outside the United States, but this tax incentive would exist only for the subset of multinational businesses that resulted from an acquisition of a domestic corporation by a foreign corporation.

Fundamental disparities unaddressed

If the proposal identifies objectionable cross-border mergers and acquisitions with appropriate scope, it does not address fundamental features of the Code that may encourage these transactions. Consequently, even if the proposal were adopted, it might not stop transactions that are viewed as objectionable; those transactions might be structured in ways intended to avoid the proposal.

To the extent U.S. tax considerations encourage mergers and acquisitions that create foreign parented groups, a broad reason for this tax incentive is the disparity between the U.S. taxation of U.S. parented groups and the U.S. taxation of foreign parented groups.[223] The Code imposes potentially greater taxation on both the foreign earnings and the U.S. earnings of U.S. parented groups than it does on the foreign and U.S. earnings of foreign parented groups. For foreign earnings of multinational companies, the Code taxes foreign earnings of foreign branches

[223] For contrasting analyses of tax considerations related to the recent wave of inversions, compare Edward D. Kleinbard, "'Competitiveness' Has Nothing to Do With It," *Tax Notes,* September 1, 2014, pp. 1055-69, with Kimberly S. Blanchard, letter to the editor, *Tax Notes,* September 15, 2014, p.1335, and William McBride, letter to the editor, *Tax Notes,* September 1, 2014, p. 1086.

of U.S. parented groups in the year of the earnings; taxes foreign business earnings of foreign subsidiaries of U.S. parent companies when the earnings are repatriated to the United States as dividends; and generally does not tax foreign earnings of foreign parented groups (unless the foreign earnings are earned by a foreign subsidiary of a U.S. subsidiary of the foreign parent company). Consistent with this structure, the Code creates U.S. taxation when a foreign subsidiary of a U.S. company makes a loan to or an equity investment in a U.S. shareholder, but not when the foreign subsidiary makes a loan to or an equity investment in a foreign affiliate, including a new foreign parent company following a cross-border acquisition.[224] Because many U.S. multinational companies have large amounts of untaxed, unrepatriated earnings in their foreign subsidiaries, they have large potential U.S. tax liabilities if they are considering repatriating those earnings to, or otherwise accessing those earnings in, the United States. If they remain U.S. parented, these multinational companies also face potential U.S. taxation on future foreign earnings. And if a U.S. parented company undertakes a merger with a foreign parented company and the combined group has a U.S. rather than foreign parent, the foreign earnings of the foreign merger partner are brought into the U.S. taxing jurisdiction.

As for U.S. earnings of multinational companies, multinational companies that are foreign parented may be able to reduce U.S. tax on U.S. earnings more readily than can multinational companies that are U.S. parented. For example, subject to the section 163(j) limitations on the deductibility of interest payments on related-party loans, a foreign parent company or its foreign affiliate may loan funds to a U.S. subsidiary so that the U.S. subsidiary can reduce its U.S. earnings with deductible interest payments on the loan. If, by contrast, a multinational company has a U.S. parent company with foreign subsidiaries, and one of the foreign subsidiaries makes a loan to its U.S. parent, the U.S. parent generally cannot use deductible interest payments to reduce its U.S. earnings because the loan generally is considered an investment in U.S. property and thereby triggers an income inclusion to the U.S. parent company under section 956, and the interest on the loan is subpart F income, includible to the U.S. parent company, when received by the foreign subsidiary. As a business matter, a foreign parented multinational company may be better positioned than a U.S. parented multinational company to locate functions performed for the multinational group, such as oversight and managerial functions, outside the United States and thereby generate deductible payments for those functions for U.S. members of the group.

The proposal responds to the disparity between the U.S. taxation of U.S. parented groups and the U.S. taxation of foreign parented groups by making it more difficult for a U.S. parented group to become a foreign parented group. The proposal does not lessen the disparity. If a goal were to lessen or eliminate the disparity, various approaches might be taken. One approach would be to broaden the U.S. base for taxing foreign parented companies or to make it more difficult for foreign parented companies to reduce U.S. earnings on which U.S. tax might be imposed. For example, new restrictions could be imposed on the deductibility of amounts such as interest paid by U.S. members of a foreign parented group. The Administration's proposal to restrict deductions for excessive interest of members of financial reporting groups takes this approach, as do recent legislative proposals and previous budget proposals of President Obama

[224] Sec. 956.

and President Bush.[225] Other commentators have proposed an upfront surtax on deductible U.S.-source related party, cross border payments, with a potential refund to the extent the payment was no greater than the amount suggested by application of a residual profit-split transfer pricing analysis.[226] More thoroughgoing changes to broaden the U.S. tax base for foreign firms could include reform of the source rules in a manner that causes more income of foreign taxpayers to be considered to have a U.S. nexus.[227]

A contrasting approach to reducing the differences in the U.S. taxation of U.S. parented and foreign parented groups would be to ease the U.S. taxation of U.S. parented groups by reducing or eliminating U.S. taxation of foreign business earnings of U.S. companies and by reducing the U.S. statutory corporate tax rate.[228] If U.S. taxation of foreign business earnings of U.S. firms were reduced but not completely eliminated, a question would be whether the U.S. statutory corporate tax rate of 35 percent, or even a lower rate provided by reform (such as the 25 percent rate in Chairman Camp's discussion draft, the Tax Reform Act of 2014), would be an independent incentive for a multinational company to be foreign rather than U.S. parented.

More ambitious reform to reduce or eliminate the disparity between the U.S. taxation of U.S. parented groups and the U.S. taxation of foreign parented groups would be to adopt a cross-border taxation scheme that applied to multinational businesses, domestic or foreign parented, in entirely or largely the same manner. For example, the United States could adopt a global system

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[225] For a description and analysis of the Administration's excessive interest proposal, see *supra,* pp. 19-23. Senator Schumer introduced a bill that tightens the section 163(j) earnings stripping rules for any corporation that has at any time inverted at a greater than 50 percent and less than 80 percent historic ownership level. S. 2796, "Corporate Inverters Earnings Stripping Reform Act of 2014," 113th Cong., 2d Sess. (2014). Representative Levin previously released a discussion draft of legislation that, among other things, tightens the section 163(j) earnings stripping rules for all corporations, not just inverted companies. Stop Corporate Earnings Stripping Act of 2014, Tax Analysts Document Number Doc 2014-19321, 2014 TNT 149-68, July 31, 2014. For three different examples of budget proposals to amend section 163(j), see Department of the Treasury, *General Explanation of the Administration's Fiscal Year 2004 Revenue Proposals,* February 2003, "Limit Related Party Interest Deductions," pp. 104-06 (among other things, applying different debt-to-asset thresholds to different categories of assets); *General Explanation of the Administration's Fiscal Year 2005 Revenue Proposals,* February 2004, "Limit Related Party Interest Deductions," p. 115 (eliminating debt-equity safe harbor, reducing adjusted taxable income threshold, reducing indefinite carryforward of disallowed interest and eliminating excess limitation carryforward); *General Explanation of the Administration's Fiscal Year 2009 Revenue Proposals,* "Limit Related Party Interest Deductions," pp. 97-98 (similar amendments applied only to inverted companies).

[226] Cym Lowell and Bret Wells, "Homeless Income and Tax Base Erosion: Source Is the Linchpin," *Tax Law Review,* vol. 65, spring 2012, pp. 535-617.

[227] For a criticism of U.S. source of income rules and suggestions for reform see Stephen E. Shay, J. Clifton Fleming, Robert Peroni, "What's Source Got to Do With It? Source Rules and U.S. International Taxation," *Tax Law Review,* vol. 56, fall 2002, pp. 81-155.

[228] Some recent U.S. international tax reform proposals such as House Ways and Means Committee Chairman Dave Camp's Tax Reform Act of 2014 discussion draft (which provides a dividend exemption system for taxing foreign earnings of U.S. multinational companies and lowers the statutory corporate tax rate to 25 percent), are intended to reform the U.S. international tax rules in this manner. See also S. 2091, United States Job Creation and International Tax Reform Act of 2012, 112th Cong., 2d Sess. (2012) (Sen. Enzi).

of formulary apportionment under which the United States would tax all multinational businesses with a U.S. nexus, whether U.S. or foreign parented, on income apportioned to the United States based on the same chosen formula.[229] As a different example, the United States could adopt a set of rules that taxed multinational companies' net business cash flows entirely based on the destination of income-producing sales and services.[230]

A narrower approach to addressing the disparities between the taxation of U.S. parented and of foreign parented groups would not address the disparities for all companies but instead would be intended to reduce the disparities only as applied to inverted companies. The recent Treasury notice and Senator Schumer's legislation take this approach.[231]

Because the proposal does not address structural features of the Code that may encourage cross-border transactions that the proposal is intended to catch, companies may undertake these transactions in modified form even if the proposal were enacted. For example, if a U.S. company and a slightly or somewhat smaller foreign company were considering a merger, they might structure a transaction in a manner that caused the owners of the U.S. company to own no more than half the stock of the new parent company of the combined group. One way to reduce the historic U.S. company shareholders' percentage ownership of the new parent company would be to use more cash and less stock as consideration for an acquisition. In other words, enough shareholders of the U.S. company could have their interests in the combined company purchased for cash that the proposal's 50-percent threshold would not be reached. So long as the new parent company were not primarily managed and controlled in the United States, this new parent company would be respected as a foreign company. A question is whether a relevant policy objective will have been accomplished to the extent the proposal shifts the consideration used in cross-border transactions away from stock and toward cash.

Administrative and compliance concerns

For U.S. companies that undertake cross-border mergers or acquisitions, the proposal's management-and-control plus substantial U.S. business activities test shifts the rule for U.S. tax residence from a purely formal one (place of incorporation) to a substantive rule based on the location of the post-acquisition company's management, employees, tangible capital, and sales. This substantive test promotes a broader policy goal of aligning U.S. corporate taxation with a corporation's allocation of labor and tangible capital. This broader policy goal may come at the expense of simplicity and certainty in administration and compliance.

The meaning of primary place of management and control would need to be specified in greater detail. For example, the definition of primary place of management and control in the

[229] Herman B. Bouma, "The Greatest Impediment to a Rational International Tax System," *Tax Management International Journal*, July 2014, pp. 434-435.

[230] Alan J. Auerbach, "A Modern Corporate Tax," Center for American Progress and The Hamilton Project, December 2010, available at http://www.hamiltonproject.org/files/downloads_and_links/FINAL_AuerbachPaper.pdf.

[231] For Senator Schumer's legislation, see footnote 225 above.

limitation on benefits article of the U.S. Model Income Tax Convention, a definition that is mirrored in a number of recent U.S. treaties, is "the Contracting State of which [a company] is a resident only if executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including its direct and indirect subsidiaries) in that State than in any other state and the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions in that State than in any other state."[232] Consistent with this treaty definition, in its 2005 legislative option to amend the rules for determining corporate residency, the staff of the Joint Committee on Taxation defined primary place of a corporation's management and control as the country "where the executive officers and senior management of the corporation exercise day-to-day responsibility for the strategic, financial, and operational policy decision making for the company (including direct and indirect subsidiaries)."[233]

These definitions, and any other definition, of primary place of management and control, are subjective. If a multinational company has business operations in countries around the world, it may be hard for the company and the IRS to ascertain the company's primary place of management and control. Identifying the primary place of management and control may be particularly difficult in situations in which multinational corporations have decentralized management structures in which different managerial functions are carried out in different countries.[234] And unlike the place of incorporation, which is fixed, the location of primary management and control may change from one year to the next as a company's operations evolve over time. Consequently, if in a given year the country in which a company is primarily managed and controlled is clear, in a subsequent year the location may change. Under the proposal, the tax residence of the company may change, and this change will have significant corresponding one-time and permanent tax consequences.

If the 50-percent historic ownership threshold is not satisfied, the proposal treats a new foreign parent corporation as a domestic corporation only if it is primarily managed and controlled in the United States and if the affiliated group of which it is a member has substantial business activities in the United States. Like primary place of management and control, substantial U.S. business activities is subjective and would need further defining. One question in this context is whether the proposal intends to use the present law regulatory definition of substantial business activities. That definition, which, if satisfied, permits a foreign corporation that has substantial business activities in its country of organization to avoid application of the

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[232] U.S Model Income Tax Convention of November 15, 2006, article 22, paragraph 5(d).

[233] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005, p. 180 (hereinafter "Joint Committee Management and Control Option").

[234] For a description of the ways in which contemporary multinational companies have allocated headquarters activities across multiple countries, see Mihir A. Desai, "The Decentering of the Global Firm," *World Economy,* vol. 32, September 2009, pp. 1271-90. The Joint Committee staff option acknowledged that some companies have decentralized management structures: "In this situation, individuals who are not executive officers and senior management employees of the corporate headquarters may be carrying on the strategic, financial, and operational policy decisions for the company. The decision-making activities of these individuals are taken into consideration in determining the company's residence. Joint Committee Management and Control Option, p. 180.

anti-inversion rules, implements a subjective rule with the objective requirement that at least 25 percent of the group's tangible assets, employees, compensation, and income be based in the country in question.[235] If the proposal intends to use this definition, a further question is whether the proposal's substantial business activities definition would be modified if the present law regulatory definition were changed.

Coordination with income tax treaties

The proposal may increase the frequency of situations in which a corporation's residence under U.S. tax law may differ from the corporation's residence under a U.S. tax treaty. The present law anti-inversion rules address this possible conflict (and other conflicts) between domestic tax law and treaties by explicitly providing that the anti-inversion rules override any contrary treaty provisions.[236] The proposal says nothing about this treaty override rule. It therefore can be assumed that the proposal is similarly intended to override treaties.

Treaty overrides can be expected in relation to the proposal's management and control rule. Take, for example, the treaty between the United States and the United Kingdom. Like many other treaties, the U.S.-U.K. treaty provides that a company is resident in the country in which it is liable to tax by reason of its place of incorporation or place of management.[237] If a U.S. multinational company undertakes a merger transaction with a foreign multinational company and the parent company of the combined group is incorporated in the United Kingdom but the group is primarily managed and controlled in the United States and has substantial business activities in the United States, the treaty might consider the parent company to be a U.K. resident because it is incorporated there,[238] but the proposal's management and control rule would cause U.S. internal law to treat the parent company as a U.S. company (unless the group had substantial business activities in the United Kingdom). In this situation the treaty override rule of present law would presumably have the consequence that the proposal's treatment of the company as a domestic corporation would override the treaty's possible treatment of the company as a U.K. resident.

Partnership rule

The proposal includes a broadening of the present law anti-inversion rule for acquisitions involving domestic partnerships. For an acquisition involving a domestic partnership rather than

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[235] Temp. Treas. Reg. sec. 1.7874-3T(b).

[236] Sec. 7874(f).

[237] Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and Fiscal Evasion with Respect to Taxes on Income and on Capital Gains ("U.S.-U.K. treaty"), article 4, paragraph 1.

[238] The treaty provides that if a company is considered a resident of both countries by reason of the general residence rule for companies, the competent authorities must determine the residence of the company by mutual agreement. If they fail to agree, the company generally is not eligible for treaty benefits. U.S.-U.K. treaty, article 4, paragraph 5.

a domestic corporation, the anti-inversion rules are triggered only if the acquisition is of "substantially all of the properties constituting a trade or business of a domestic partnership."[239] The proposal provides that the anti-inversion rules are also triggered if the acquisition is of "substantially all of the assets of a domestic partnership (regardless of whether such assets constitute a trade or business)." This seemingly narrowly written rule may be intended to stop avoidance of the anti-inversion rules in circumstances in which, for example, the only asset of a domestic partnership is stock of a domestic corporation, and a foreign corporation acquires this stock (and the acquisition of the domestic corporation stock is not an acquisition of substantially all of the properties of the domestic corporation; if it were, the present law anti-inversion rules would apply). Read literally, the present law rule may not cover this transaction because the stock of the domestic corporation, the domestic partnership's sole asset, may not be considered to "constitut[e] a trade or business" of the partnership.

It is unclear whether this literal reading would survive an IRS challenge. Moreover, the section 7874 anti-inversion rules delegate to the Secretary of the Treasury broad authority to "provide such regulations as are necessary to carry out [section 7874], including regulations for such adjustments to the application of [section 7874] as are necessary to prevent the avoidance of the purposes of [section 7874], including the avoidance of such purposes through – (1) the use of related persons, pass-through or other non-corporate entities, or other intermediaries."[240] Given this broad regulatory authority and, in particular, Congress's explicit concern that regulations be issued to prevent avoidance through the use of pass-through entities, it is unclear whether the proposal's special partnership rule is necessary or makes a meaningful change to present law.

[239] Sec. 7874(a)(2)(B)(i).

[240] Sec. 7874(g).

PART VI − REFORM TREATMENT OF FINANCIAL AND INSURANCE INDUSTRY INSTITUTIONS AND PRODUCTS

A. Require that Derivative Contracts be Marked to Market with Resulting Gain or Loss Treated as Ordinary

Present Law

In general

A derivative is a contract in which the amount of at least one contractual payment is calculated from the change in value of something (or a combination of things) that is fixed only after the contract is entered into. The thing that fixes the payment amount(s) and hence the derivative's value is called the underlying; examples include assets, liabilities, indices, and events. The most common forms of derivative are options, forwards, futures, and swaps. The taxation of derivatives has developed over a long period without a consistent underlying policy. The tax rules apply differently depending on the form of the derivative, the type of taxpayer entering into it, the purpose of the transaction, and other factors. The rules are complex and may be uncertain in their application.

Options

An option is a derivative in which one party purchases the right to deliver or receive a specified thing to or from another party on a fixed date or over a fixed period of time in exchange for a payment whose value is fixed when the contract is entered into. The purchaser of the option is also called the holder; the seller of the option is also called the writer or issuer. When the option purchaser gives or receives the specified thing to the other party in exchange for the payment, the purchaser is said to exercise its right. The latest time the purchaser can exercise its right is called the expiration date. The thing that is delivered or that fixes the amount of payment at the expiration date is called the underlying. The payment by the purchaser for the option is called the premium, and the payment made for the thing at expiration is called the strike price. A European-style option is an option that can only be exercised at the expiration date. An American-style option is an option that can be exercised at any time prior to the expiration date.

A call option is an option in which the option purchaser has the right to buy a specified thing. A put option is an option in which the option purchaser has the right to sell a specified thing. Payment at the expiration date can take many forms. An option is called "physically settled" when the underlying is delivered from one party to the other. An option is called "cash settled" when one party pays cash equal to the difference between the strike price and the value of the underlying at the expiration date.

In general,[241] no tax consequences are recognized upon entering into an option contract, even though option premiums are paid without any possibility for recovery or return. The option purchaser's premium payment is nondeductible, and the option seller does not include the

[241] This discussion does not address options granted in connection with the performance of services.

premium payment in income.[242] For the purchaser of a put option, if the option is exercised, the premium reduces the amount received in the sale of the underlying. For the purchaser of a call option, if the option is exercised, the premium becomes part of the basis in the property acquired.

For an option purchaser, gain or loss attributable to the sale or exchange, or loss from failure to exercise an option, is gain or loss from property of the same character as the option's underlying.[243] An option is treated as sold or exchanged on the day it expires without exercise in determining whether the loss is short term or long term.[244] A seller of an option has ordinary income if the option is not exercised,[245] but if the option is with respect to "property," any gain or loss from closing or lapse is short term capital gain.[246] For this purpose, "property" includes stocks, securities, commodities, and commodity futures.[247] If an option purchaser exercises a cash settled option, then gain or loss is short term or long term depending on whether the option purchaser has held the option for more than one year.[248] If an option purchaser exercises a physically settled option, the holding period for the property delivered is calculated from the date the option is exercised.[249] Option purchasers may be treated differently depending on whether they hold cash settled or physically settled options, even though their economic positions may be similar.[250]

Timing and character results for options and the other derivatives described below may be different depending on the type of taxpayer entering into the option (for example, whether a dealer in securities), on the use of the option (for example, as a hedge), the underlying, the type of option (for example, whether traded on a U.S. exchange), or the application of other overriding rules (for example, the straddle rules).

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[242] Rev. Rul. 78-182, 1978-1 C.B. 265. Courts decided receipt of option premiums were nontaxable because it could not be determined if the premium were gain or return of capital until expiration. *Virginia Coal & Coke Co. v. Commissioner*, 37 BTA 195, aff'd, 99 F2d 919 (4th Cir. 1938), cert. denied, 307 US 630 (1939).

[243] Sec. 1234(a).

[244] Sec. 1234(a)(2).

[245] Treas. Reg. sec. 1.1234-1(b).

[246] Sec. 1234(b).

[247] Sec. 1234(b)(2)(B).

[248] Rev. Rul. 88-31, 1988-1 C.B. 302.

[249] *Ibid.* The new holding period begins on the day the option is exercised if the underlying is stock or other securities acquired from the corporation that issued the securities. Sec. 1223(5). Otherwise, the holding period begins the day after the option is exercised. *Weir v. Commissioner*, 10 T.C. 996 (1948).

[250] An investor who holds a cash settled option for a period longer than one year and who exercises that option is eligible for long term capital gain treatment. If an investor holds a physically settled option for a period longer than one year, exercises the option, and sells the underlying asset immediately, any capital gain on the transaction is short term capital gain to the investor.

Forwards

A forward is a derivative in which one party agrees to deliver a specified thing to another party on a fixed date in exchange for a payment whose value is fixed when the contract is entered into. The party agreeing to deliver the thing is called the short party; the party agreeing to pay is called the long party. The date on which the short party must deliver is called the delivery or expiration date. The thing that is delivered or that fixes the amount of payment at the expiration date is called the underlying. The payment by the long party at delivery is called the forward price. For most forwards, no payment is made when the contract is signed. For a prepaid forward, the long party pays the short party the forward price (discounted to present value on the date of the payment) at the time the parties enter into the contract.[251] A variable forward requires the short party to deliver an amount of property that varies according to a formula agreed to when the contract is signed.[252]

A forward is called "physically settled" if the underlying is delivered from one party to the other. A forward is called "cash settled" if one party pays cash equal to the difference between the forward price and the value of the underlying on the delivery date.

In general, no tax consequences are recognized on entering into a forward.[253] If a forward is physically settled, the short party recognizes gain or loss in the amount of the difference between the forward price and the short party's basis in the property in the year in which the delivery takes place.[254] The long party reflects the forward price as the basis in the property acquired; any gain or loss is deferred until a subsequent realization event.

In general, the character of the gain or loss with respect to a forward is the same as the character of the property delivered.[255] Gain or loss on the sale or exchange of a forward is long term capital gain or loss if the contract has been held for longer than the requisite holding period.[256] Cash settlement of a forward is treated as a sale or exchange.[257]

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[251] See Notice 2008-2, 2008-1 C.B. 252.

[252] See, for example, *Anschutz Co. v. Commissioner*, 664 F.3d 313 (10th Cir. 2011).

[253] However, if the forward buyer obtains possession of the underlying property prior to the delivery date specified in the contract, the transaction may be considered "closed" for tax purposes, and the transfer of possession may be treated as a realization event. See, for example, *Commissioner v. Union P. R. Co*., 86 F.2d 637 (2d Cir. 1936) and *Merrill v. Commissioner*, 40 T.C. 66 (1963).

[254] Sec. 1001.

[255] Sec. 1234A and Prop. Treas. Reg. sec. 1.1234A-1(c)(1).

[256] *Carborundum Co. v. Commissioner*, 74 T.C. 730, 733-42 (1980); *American Home Products Corp. v. United States*, 220 Ct. Cl. 369, 383-87 (Ct. Cl. 1979); *Hoover Co. v. Commissioner*, 72 T.C. 206, 250 (1979), nonacq., 1980-2 C.B. 2.

[257] *Estate of Israel v. Commissioner*, 108 T.C. 208, 217 (1997).

If a forward qualifies as a commodity futures contract not subject to section 1256,[258] the long party's holding period of the underlying includes the period in which the party held the contract.[259] For other physically settled forwards, the holding period of the underlying begins when the burdens and benefits of ownership are transferred from the short to the long party.[260] For short parties to physically settled securities forwards and commodities futures, section 1233 and the accompanying regulations provide rules regarding holding period determinations,[261] although these rules have been partially supplanted by section 1234B (governing certain securities futures contracts) and section 1256 (governing regulated commodities futures contracts). For transactions to which section 1233 still applies, a short party that physically delivers property to close a contract recognizes capital gain or loss on the transaction as short term or long term depending on the period for which the short party holds the property prior to delivery.[262] If a short party closes out a physically settled contract by purchasing the underlying asset and immediately delivering it to fulfill its contractual obligations, any capital gain or loss to the short party is short term capital gain or loss.[263]

Forwards for the sale of a single security or a narrow-based security index[264] are subject to a separate regime under section 1234B. Gain or loss attributable to the sale, exchange, or termination of a securities futures contract is considered gain or loss from the sale or exchange of property that has the same character as the property to which the contract relates has (or would have) in the taxpayer's hands. Section 1234B also provides that gain or loss on a securities

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[258] The scope of section 1256 is discussed in detail below.

[259] Sec. 1223(7); see also Treas. Reg. sec. 1.1223-1(h). If the contract is physically settled and section 1256 does apply, then the taxpayer's holding period begins on the delivery date and does not include the prior period during which the taxpayer held the contract. Sec. 1256(c).

[260] Rev. Rul. 69-93, 1969-1 C.B. 139. In a case involving a physically settled forward for the sale of convertible debentures, one court held that the long party's holding period with respect to the debentures did not begin until delivery of the underlying debentures where: (1) the short party continued to receive interest payments on the debentures while the forward was open; (2) the short party was free to sell the debentures while the contract was open (provided that the short party delivered substantially identical property on the delivery date); and (3) the short party was free to use the debentures as security for other financial transactions. *Stanley v. United States*, 436 F. Supp. 581, 583 (N.D. Miss. 1977).

[261] Although the statutory text of section 1233 only makes reference to "short sales," the accompanying regulations indicate that section 1233 applies to forward contracts as well. See Treas. Reg. sec. 1.1233-1(c)(6) (example 6); see also *Hoover Co. v. Commissioner*, 72 T.C. 206, 249 (1979) (applying section 1233 to certain forward contracts).

[262] Sec. 1233(a)-(b).

[263] General Counsel Memorandum 39304, November 5, 1984.

[264] The term "narrow-based security index" includes indexes with nine or fewer component securities, indexes that are heavily weighted toward a small number of component securities, or indexes weighted toward securities with low trading volumes. 15 U.S.C. sec. 78c(a)(55). An option on a broad-based security index is treated as a nonequity option and is subject to section 1256.

futures contract, if capital, is treated as short term capital gain or loss regardless of the taxpayer's holding period.

Swaps and notional principal contracts

"Notional principal contract" is the term in the tax law closest to what is colloquially known as "swap." The tax term covers a narrower range of contracts than the colloquial term.[265] Treasury regulations define a notional principal contract as a financial instrument that provides for the payment of amounts by one party to another party at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.[266] A specified index is defined as a fixed rate, price, or amount that must be based on objective financial information not in control of either party. A notional principal amount is defined as a specified amount of money or property that, when multiplied by a specified index, measures a party's rights and obligations under the contract but is not borrowed or loaned between the parties.

Examples of notional principal contracts include interest rate swaps, currency swaps, and equity swaps.[267] Treasury regulations exclude certain instruments from the definition of notional principal contract including: (1) section 1256 contracts, (2) futures contracts, (3) forwards, (4) options, and (5) instruments or contracts that constitute indebtedness for Federal tax purposes.

For purposes of calculating the inclusion of income or expense flowing from a notional principal contract, the regulations divide payments exchanged by the parties to the contract into: (1) periodic payments (made at least annually); (2) termination payments (made at the end of the contract's life); and (3) nonperiodic payments (neither (1) nor (2)).[268] Taxpayers must recognize periodic and nonperiodic payments using a specified accrual method for the taxable year to which the payment relates, and must recognize a termination payment in the year the notional principal contract is extinguished, assigned, or terminated.[269] A swap with a significant[270] nonperiodic payment is treated as two transactions: an on-market level payment swap and a loan.[271] The loan must be accounted for independently of the swap. Treasury regulations

[265] An example of a contract that is encompassed within the term "swap" is a bullet swap, which is a single-payment swap; whether it constitutes a notional principal contract under current law is uncertain. For a discussion of proposed regulations addressing bullet swaps, see Joint Committee on Taxation, *Present Law and Issues Related to the Taxation of Financial Instruments and Products* (JCX-56-11), December 2, 2011, fn. 134.

[266] Treas. Reg. sec. 1.446-3(c)(1)(i).

[267] *Ibid*.

[268] Treas. Reg. sec. 1.446-3(e), (f) and (h).

[269] *Ibid*.

[270] The term "significant" is defined only through examples that leave a large area of uncertainty as to what constitutes a "significant" nonperiodic payment.

[271] See Treas. Reg. sec. 1.446-3(g)(6), example 3.

proposed in 2004 under section 1234A, contingent nonperiodic payments (such as a single payment at termination tied to the change in value of the underlying) are accrued over the life of the swap based on an estimate of the amount of the payment.[272] The amount of a taxpayer's accrual is redetermined periodically as more information becomes available.[273]

Final Treasury regulations do not address the character of notional principal contract payments. However, the 2004 proposed regulations provide that any periodic or nonperiodic payment generally constitutes ordinary income or expense.[274] The preamble to the 2004 proposed regulations explains that ordinary income treatment is warranted because neither periodic nor nonperiodic payments involve the sale or exchange of a capital asset. The 2004 proposed regulations provide that gain or loss attributable to the termination of a notional principal contract is capital if the contract is a capital asset of the taxpayer but do not specify whether a taxpayer who holds a notional principal contract for more than one year should recognize capital gain or loss on account of a termination payment as short term or long term. Those regulations do provide that final settlement payments with respect to a notional principal contract are not termination payments under section 1234A.[275]

Section 1256 contracts

Section 1256 provides timing and character rules for defined types of derivatives. Any section 1256 contract held by a taxpayer at the close of a taxable year is marked to market, that is, the contract is treated as having been sold by the taxpayer for its fair market value on the last business day of the taxable year.[276] The character of gain or loss on the mark to market, or if the contract is terminated or transferred,[277] is 60 percent long term capital gain or loss, and 40 percent short term capital gain or loss, regardless of the taxpayer's holding period.[278] Different character rules apply to foreign currency contracts that come within both sections 1256 and 988.[279]

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[272] Notional Principal Contracts; Contingent Nonperiodic Payments: Notice of Proposed Rulemaking, Fed. Reg. vol. 69, 38, February 26, 2004, p. 8886 (the "2004 proposed regulations").

[273] *Ibid*.

[274] Prop. Treas. Reg. sec. 1.1234A-1.

[275] Prop. Treas. Reg. sec. 1.1234A-1(b).

[276] Sec. 1256(a)(1).

[277] Sec. 1256(c)(1).

[278] Sec. 1256(a)(3). This general rule does not apply to 1256 contracts that are part of certain hedging transactions or section 1256 contracts that, but for the rule in section 1256(a)(3), would be ordinary income property.

[279] The interaction between section 988 governing foreign currency transactions and section 1256 is extremely complex, *see* Viva Hammer, "U.S. Taxation of Foreign Currency Derivatives: 30 Years of Uncertainty,"

A section 1256 contract is defined as: (1) a regulated futures contract,[280] (2) a foreign currency contract, (3) a nonequity option traded on or subject to the rules of a qualified board or exchange,[281] (4) an equity option purchased or granted by an options dealer that is listed on a qualified board or exchange on which the dealer is registered,[282] and (5) a securities futures contract entered into by a dealer that is traded on a qualified board or exchange. Excluded from the definition of section 1256 contracts are (1) any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract and (2) any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.[283]

Mark to market accounting for dealers and traders

Section 475 requires that securities dealers – taxpayers that regularly purchase securities from or sell securities to customers in the ordinary course of business – recognize gain and loss on a mark to market basis. The term "security" is defined to include stocks, interests in widely held or publicly traded partnerships and trusts, debt instruments, interest rate swaps, currency swaps, and equity swaps, as well as options, forwards, and short positions on any of the above-mentioned financial instruments, and other positions identified as hedges with respect to any of the above-mentioned instruments.[284] The statute also allows traders in securities to elect into mark to market, and it allows traders in commodities to opt into the mark to market regime and to have their commodity holdings treated analogously to securities under section 475.[285]

For taxpayers required to follow the mark to market rules or who elect into those rules, securities or commodities in the hands of the taxpayer at the close of a tax year must be treated as if they were sold for their fair market value on the last business day of the year. All resulting mark to market gains or losses with respect to such securities or commodities are treated as ordinary.[286] However, mark to market accounting is neither required nor permitted for: (1) securities held for investment; (2) debt instruments acquired in the ordinary course of a trade or business (unless those debt instruments are held for sale, in which case they must be marked to

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Bulletin of International Taxation, vol. 64, no. 3, March 2010, expanded and updated in Practising Law Institute, *Taxation of Financial Products and Transactions,* Matthew A. Stevens (ed.), 2013.

[280] A contract is a regulated futures contract if the parties are required to post margin on a mark to market basis and the contract is traded on or subject to the rules of a qualified board or exchange. Sec. 1256(g)(1).

[281] An option on a narrow-based security index is treated as an equity option and therefore not a section 1256 contract.

[282] Sec. 1256(g)(4).

[283] Sec. 1256(b)(2).

[284] Sec. 475(c)(2).

[285] Sec. 475(f).

[286] Sec. 475(d)(3).

market); and (3) for securities that are held as hedges (unless the security is a hedge for another security that is inventory in the hands of the dealer, in which case the hedge must be marked to market as well).[287]

Straddles

Section 1092 defines a straddle as offsetting positions with respect to actively traded property.[288] Positions are offsetting if there is a substantial diminution of risk of loss from holding any position in actively traded property by holding one or more other positions with respect to actively traded property.[289] Section 1092(a) provides that a taxpayer's loss with respect to one position that is part of a straddle may only be taken into account to the extent that the loss exceeds the taxpayer's unrecognized gain with respect to any offsetting position that is part of the straddle. The taxpayer may carry forward any disallowed loss into succeeding taxable years and may take such loss into account once the taxpayer disposes of the offsetting position.[290]

Exceptions from the straddle rules are provided for hedging transactions,[291] straddles composed entirely of section 1256 contracts,[292] and qualified covered calls.[293] Special rules apply for mixed straddles (generally, straddles comprised of both section 1256 contracts and non-section 1256 contracts)[294] and for identified straddles.[295]

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[287] Sec. 475(b)(1).

[288] Sec. 1092(c)(1) and (d)(1).

[289] Sec. 1092(c)(2)(A). "Substantial diminution of risk of loss" is an undefined term and its meaning is uncertain.

[290] Sec. 1092(a)(1).

[291] Sec. 1092(e). A hedging transaction is a transaction entered into in the normal course of the taxpayer's trade or business primarily to manage the risk of price changes or currency fluctuations with respect to ordinary property held by the taxpayer or to manage the risk of interest rate changes, price changes, or currency fluctuations with respect to borrowings made or ordinary obligations incurred by the taxpayer. Sec. 1221(b)(2)(A). To qualify as a hedging transaction for purposes of the straddle rule exception, the transaction must be clearly identified as such before the close of the day on which the transaction was entered into. Sec. 1256(e)(2).

[292] Sec. 1256(a)(4).

[293] Sec. 1092(c)(4); Treas. Reg. sec. 1.1092(c)1(b).

[294] Sec. 1092(b)(2). If a straddle consists of positions that are section 1256 contracts and non-section 1256 contracts, the taxpayer may designate the positions as a mixed straddle. Positions in a mixed straddle are not subject to the mark to market rule of section 1256, but instead are subject to regulations designed to prevent the deferral of tax or the conversion of short term capital gain into long term capital gain or the conversion of long term capital loss into short term capital loss.

[295] Sec. 1092(a)(2). If a taxpayer clearly identifies a straddle as such before the close of the day on which the straddle is acquired, then the loss deferral rules of section 1092(a) do not apply. Instead, any loss incurred with respect to a position that is part of an identified straddle is added to the tax basis of the offsetting positions in the

Identification of hedges

Several provisions governing the taxation of derivatives grant special treatment to "identified" hedges. The mark to market requirement under section 475 does not apply to any security which is identified as a hedge with respect to a position, right, or liability that is not itself subject to the mark to market rule.[296] Likewise, the mark to market requirement under section 1256 does not apply to a transaction that the taxpayer identifies as a hedging transaction.[297]

Hedges must be identified by the close of the day on which a taxpayer enters into the hedging transaction.[298] The identification must be made on, and retained as part of, the taxpayer's books and records.[299] The identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy this requirement unless the taxpayer's books and records indicate that the nontax identification is also being made for tax purposes.[300]

Description of Proposal[301]

The proposal requires all taxpayers to recognize gain or loss from their derivative contracts as if the contracts were sold for their fair market value on the last business day of the taxpayers' taxable year. Gain and loss resulting from derivative contracts are treated as ordinary income or loss attributable to a trade or business of the taxpayer. No new rule is proposed for the sourcing of flows from derivatives.

The proposal defines derivative contract to include any contract the value of which is determined, directly or indirectly, by the value of actively traded property. The proposal also requires derivative contracts embedded in other financial instruments, such as contingent payment debt instruments or structured notes linked to actively traded property, to be marked to market.[302] The proposal does not require other types of financial instruments, such as stocks and

straddle. Sec. 1092(a)(2)(A); William R. Pomierski, "Identified Straddles: Uncertainties Resolved and Created by 2007 Technical Corrections," *Journal of Taxation of Financial Products*, vol. 7, no. 2, 2008, pp. 5-10, 55-57.

[296] Sec. 475(b)(1)(C), (2).

[297] Sec. 1256(e).

[298] Treas. Reg. sec. 1.1221-2(f)(1).

[299] Treas. Reg. sec. 1.1221-2(f)(4)(i).

[300] Treas. Reg. sec. 1.1221-2(f)(4)(ii).

[301] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), Item VI. A., reprinted in the back of this volume.

[302] One common example of derivative embedded in another financial instrument is a convertible bond, which can be viewed as a bond with an "embedded" option to purchase equity in the issuer. It is not clear whether the proposal is intended to apply to bonds that are convertible into the issuer's own stock.

bonds, to be marked to market. However, if a taxpayer enters into a derivative that substantially diminishes the risk of loss with respect to actively traded stock, then the stock is required to be marked to market with built in gain (but not loss) recognized at the time the derivative is entered into.

The proposal gives the Secretary authority to issue regulations matching the timing, source and character of income, gain, deduction and loss from a capital asset and a transaction that diminishes the risk of loss and opportunity for gain from the asset.

"Business hedging" transactions are exempt from mark to market under the proposal. A derivative contract qualifies as a business hedging transaction if the taxpayer enters into the contract in the ordinary course of its trade or business primarily to manage the risk of price changes (including interest rate changes, currency fluctuations, and credit deterioration) with respect to ordinary property or ordinary obligations, provided that the taxpayer specifically identifies the derivative contract as a hedging transaction before the close of the day on which the taxpayer enters into the contract. Under the proposal, a taxpayer satisfies the identification requirement if the taxpayer identifies the transaction as a business hedge for financial accounting purposes.

The proposal eliminates or amends several Code sections: 475, 1092, 1233, 1234, 1234A, 1256, 1258, 1259, and 1260. It is not stated which of these sections would be eliminated and what amendments would be made to those that remain.

Effective date.−The proposal applies to derivative contracts entered into after December 31, 2014.

Analysis

Standardizing the treatment of timing and character

Present law leads to inconsistencies, complexities and uncertainties in the tax treatment of derivatives, resulting in opportunities for unintended tax benefits for the well-advised and traps for other taxpayers. The proposal seeks to provide a uniform treatment for derivatives and eliminate the problems in present law by requiring a single rule for recognition of income (mark to market) and a single rule for the character of that income (ordinary). No new rule is proposed for the sourcing of flows from derivatives.

Standardizing the categorization of economically equivalent transactions

Under present law, the tax treatment of a derivative depends largely on the form of the transaction: whether it is classified as an option, a forward, futures contract, a notional principal contract, or something else. The delineation of these forms is sometimes rigid (for example, definition of notional principal contract), and sometimes uncertain (for example, there is no uniform definition of a forward). Because of the ad hoc manner in which the rules for financial transactions developed, the current collection of statute, regulations, IRS guidance, and case law together fails to tax derivatives fairly and effectively.

An example of a transaction with multiple possible tax characterizations is the credit default swap (CDS), in which a "protection buyer" agrees to make premium payments to a "protection seller" in exchange for the seller's promise to make a "settlement payment" to the buyer in the event that a "reference entity" (*e.g.*, a corporation, a sovereign entity, a state or municipality, etc.) experiences a defined credit event. The settlement could involve a monetary payment or the delivery of referenced debt instrument/s. Controversy over the tax treatment of this transaction was unresolved by Congress or Treasury throughout the period of its rapid growth. Practitioners have suggested a number of tax characterizations, including treating CDS as insurance, a guarantee, an option, a notional principal contract, or some unclassified financial instrument. The tax consequences of these various characterizations can be significantly different one from the other and because of the lack of guidance, taxpayers (or the IRS) could take their pick of outcomes.[303] Proposed Treasury regulations adopt the position that the transactions are notional principal contracts, although these regulations have yet to take final form and there are still many unanswered questions about the taxation of CDS.[304]

The President's proposal prescribes uniform treatment for all derivative transactions linked to actively traded property, irrespective of the form of the contract, eliminating the current tax arbitrage opportunities arising from the different tax treatment of different forms of derivative. However, the proposal does not apply to derivatives with underlyings that are non-actively traded, preserving the pitfalls of the current system for these transactions, and creating new disparities between derivatives with similar underlyings, except that one is actively traded and one is not.

Providing character certainty for flows from derivatives

Current law lacks a schema for determining the character of payments flowing from derivatives as ordinary or capital. For CDS, for example, even if taxpayers determine the transaction fits the notional principal contract definition rather than other possible characterizations, the treatment of settlement payments is uncertain. Some treat them as termination payments that are capital in character,[305] while others have suggested that they are nonperiodic payments that give rise to ordinary income and expense.[306] If there is a gain, individuals may have an incentive to characterize settlement payments as termination payments giving rise to capital gain (which may be eligible for the preferential tax rate on long-term capital gain), while if there is a loss, both corporations and individuals may have an incentive to

[303] See, for example, Bruce Kayle, "Will the Real Lender Please Stand Up: The Federal Income Tax Treatment of Credit Derivative Transactions," *Tax Lawyer*, vol. 50, no. 3, 1997, pp. 569-616; Kevin J. Liss, "Are Credit Default Swaps Really Swaps or Options for Tax Purposes? An Economics-Based Approach," *Journal of Taxation of Financial Products*, vol. 7, no. 1, 2008, p. 23.

[304] Prop. Treas. Reg. sec. 1.446-3(c)(iii) (2011).

[305] Erika W. Nijenhuis, "New Tax Issues Arising From the Dodd-Frank Act and Related Changes to Market Practice for Derivatives," *Columbia Journal of Tax Law*, vol. 2, 2011, pp. 1-99.

[306] New York State Bar Association Tax Section, *Report on Credit Default Swaps*, September 9, 2005, p. 62.

characterize settlement payments as nonperiodic payments giving rise to ordinary expense. If the underlying is actively traded, the President's proposal eliminates the possibility for inconsistent treatment because all gains or losses on transactions covered by the proposal are ordinary.[307]

Standardizing the treatment of gain or loss upon termination of a transaction

Present law leads to differing character of gain or loss on final payments on derivatives depending on the way in which parties terminate their transactions, even if the economics underlying the termination methods are the same. The President's proposal eliminates this opportunity because it requires taxpayers to treat all gain or loss on covered derivatives transactions, including gain or loss attributable to the sale or termination of a derivatives contract, as ordinary in character.

Straddle transactions

The proposal provides that straddles consisting of actively traded stock and transactions that substantially diminish the risk of loss of the stock result in the stock being required to be marked to market. The proposal is silent on the character of the mark to market on the stock.

In addition, the proposal provides the Secretary authority to issue regulations matching the various tax characteristics of a capital asset and transactions that diminish the risk of loss or opportunity for gain from the asset.

Issues and questions arising from the proposal

Definition of derivative

While the President's proposal eliminates much of the uncertainty caused by current law, it also introduces new uncertainties because of the general nature of the definition of derivative contract. Some common types of transactions are potentially within the definition that might not be intended to be covered by it. For instance, if a homeowner obtains an adjustable-rate home equity loan from a bank and invests the proceeds in a fixed-rate certificate of deposit at the same bank, does that transaction become a derivative contract? The definition of derivative needs to be elaborated before the scope of the proposal is clear.

Actively traded property

The President's proposal only applies to derivatives on actively traded property. Although the proposal does not define that term, the intent may have been to rely on the same term that is defined by regulations under section 1092.[308] That section was enacted to prevent the use of straddles consisting of highly liquid derivatives and securities ("actively traded

[307] This discussion assumes that the President's proposal provides that all gain and loss on derivatives is ordinary, whether resulting from mark to market or otherwise.

[308] Treas. Reg. sec. 1.1092(d)-1.

property") to avoid recognition of income and to make conversions between ordinary income and capital gain or loss.

Under the section 1092 regulations, actively traded property is property for which there is an established financial market. The term "established financial market" includes a national securities exchange, an interdealer quotation system sponsored by a national securities association, a domestic board of trade designated as a contract market by the Commodities Futures Trading Commission, a foreign securities exchange or board of trade that satisfies analogous regulatory requirements, an interbank market, an interdealer market,[309] and a debt market.[310] Regulations refining the definition of actively traded property have been promulgated from time to time, but only with the intent of clarifying section 1092. It remains to be seen whether this body of law with its anti-abuse focus fits the President's derivative proposal. New rules focusing on appropriately taxing derivative markets rather than to prevent straddles may be needed. One problem to be addressed is the case when underlyings fluctuate between being actively traded and non-actively traded during a single taxable year. This is not uncommon for new or disappearing markets, or for currencies that are sensitive to international economic and national political changes. In addition, the proposal would need rules for the case in which a single derivative references both actively traded and non-actively traded property.

Derivatives linked to the value of investment partnerships (*e.g.*, hedge funds and private equity funds) may not be subject to the mark to market requirement because limited partnership interests in those funds may not be actively traded. It should be determined whether this is the intent of the proposal.

Embedded derivatives

If a derivative is embedded within another financial instrument, the derivative is required to be marked to market under the President's proposal if the derivative by itself would be marked to market. There is no discussion of what constitutes "embedded" in the proposal or other areas of the tax law, although the term has been defined under generally accepted accounting principles.[311] Should the derivatives in convertible bonds (*i.e.*, bonds that give their holders an embedded call option on the issuer's stock) or shares of convertible preferred stock (*i.e.*, shares of preferred stock that give their holders an embedded call option on the issuer's common stock) qualify as embedded derivatives under the President's proposal? Should the answer be different for callable bonds (*i.e.*, bonds that give the issuer an embedded call option to repurchase the bond), putable bonds (*i.e.*, bonds that give the holder an embedded put option to sell the bond back to the issuer), or extendible bonds (*i.e.*, bonds that give the issuer an embedded put option

[309] An interdealer market, in turn, is a system of general circulation that provides a reasonable basis to determine the fair market value of property based on recent price quotations or actual prices of recent transactions. Treas. Reg. sec. 1.1092(d)-1(b)(2)(i).

[310] In general, a debt market exists if price quotations are readily available from brokers, dealers, or traders (although the relevant regulation sets out several exceptions to this general rule). Treas. Reg. sec. 1.1092(d)-1(b)(2)(ii).

[311] ASC 815-15-25-1-Derivatives and Hedging.

to sell new bonds to the holder when the first bond matures)? Clarification is needed for these and other common types of instruments. In addition, derivatives embedded in other instruments raise more difficult valuation issues than other types of derivatives and specialized valuation rules will be needed for them.

Inconsistencies in the treatment of derivative and non-derivative transactions

The President's proposal does not affect the treatment of non-derivative instruments such as stocks and bonds and leaves in place the historical divide between ordinary and capital income, the preferential tax rate for long-term capital gain and the realization-based timing rules for non-derivative financial instruments. As long as these features of the tax code remain in place, tax planning opportunities arise because the new divide between non-derivative and derivative financial instruments may arise to arbitrage those differences.

Source of income

The President's proposal makes no changes to the rules regarding the source of income from derivatives transactions. The current source rules give taxpayers considerable control over the source of income from financial instruments. Congress has paid considerable attention to tax planning around sourcing rules to avoid U.S. withholding tax, among other things, most particularly in section 871(m). This tax planning and the complex statutory and regulatory rules to prevent tax avoidance are retained under the President's proposal.

Liquidity

One general criticism of a tax law that imposes mark to market, is that taxpayers may have tax on gains when they do not have sufficient liquid assets.[312] Similar concerns were voiced prior to the enactment of the original issue discount (OID) rules in 1969,[313] although taxpayers have successfully complied with those rules for over 40 years. Moreover, the existing tax regime for options and forwards already creates mismatches between cash flows and tax liabilities: both options and prepaid forwards require cash outlays by one party without immediate tax deductions. In addition, one party to a notional principal contract with significant upfront nonperiodic payments must include those payments in income over the life of the swap.

More importantly, mark to market taxation frees up taxpayers' losses without any transaction costs, and for taxpayers with a portfolio of derivatives the benefit of freed losses mitigates the tax on the unrealized gains. Although taxpayers may expect more gains than losses, the derivatives market is generally a zero sum game and so the issue of liquidity to pay for unrealized gains may be more one of perception than reality.

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[312] See, for example, Edward A. Zelinsky, "For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues," *Cardozo Law Review*, vol. 19, no. 3, December 1997, pp. 861-961.

[313] William B. Landis, "Original Issue Discount After the Tax Reform Act of 1969," *Tax Lawyer*, vol. 24, no. 3, 1971, pp. 435, 452.

In addition, under the current financial regulatory regime, far more derivatives than ever before are traded on markets requiring the posting of margin so that actual cash changes hands to reflect the change in value of a taxpayer's derivative, eliminating the problem of liquidity to pay tax.[314] In addition, the Standard Credit Support Annex to the ISDA Master Agreement, which is widely used with respect to non-cleared over-the-counter swaps, incorporates variation margin requirements that are "essentially identical" to those imposed by central clearing parties.[315]

Valuation

Another common criticism of mark to market taxation centers on valuation challenges. The proposed rule requires taxpayers to treat derivatives as if they were sold at the end of the taxable year. Without an actual sales price, taxpayers and the IRS are going to have to devise methods for finding fictional "as if sold" sales prices. If the type of derivative in question is heavily traded, finding an "as if sold" sale price is straightforward. If the derivative is less liquid, and actual evidence is lacking, taxpayers and the IRS will have to agree on a fictional value. This could involve developing algorithms, obtaining appraisals from experts, or other methods. Any of these methods may be costly, inaccurate, or both.[316]

Valuation is not a new problem; it has been discussed since before section 475 was enacted. Nevertheless, section 475 has been complied with by taxpayers, and administered by the IRS for twenty years. In addition, many disciplines in the financial world (various forms of accounting, risk management, financial forecasting, compensation) rely on mark to market and the tax profession can learn much from the theory developed in these fields.

Valuation concerns are less salient for derivatives subject to variation margin requirements because of the markets on which they trade: these contracts are already marked to market on a daily basis, so a once-yearly appraisal for tax purposes is unlikely to introduce significant new costs. For derivatives contracts linked to actively traded property that are not themselves actively traded (*e.g.*, stock options that do not follow the third-Friday-of-the-month convention[317]), valuation challenges may be more significant. However, these valuation challenges are not unlike those that other taxpayers already face under the status quo (*e.g.*, when taxpayers elect to include unvested stock options in income under section 83(b)). The IRS has addressed challenges of valuing certain options in sections 280G and 4999 (regarding golden parachute payments), adopting a safe harbor for valuations based on the Black-Scholes option pricing method.

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[314] Anupam Chander and Randall Costa, "Clearing Credit Default Swaps: A Case Study in Global Legal Convergence," *Chicago Journal of International Law*, vol. 10, no. 2, 2010, pp. 639-683.

[315] International Swaps and Derivatives Association, *ISDA Margin Survey 2013*, June 2013, p. 8.

[316] Zelinsky, "For Realization," pp. 879-89, p. 52, p. 160.

[317] Publicly traded options expire on the third Friday of the month. Thomas Lee Hazen, "Volatility and Market Inefficiency: A Commentary on the Effects of Options, Futures, and Risk Arbitrage on the Stock Market," *Washington & Lee Law Review*, vol. 44, no. 3, Summer 1987, pp. 789-805.

The benefit of the mark to market method is that taxpayers must revalue their derivatives every year and consistent year after year mis-valuation to achieve some tax advantaged goal is difficult and costly to organize. In addition, the many taxpayers using mark to market for other purposes - accounting, regulatory, trader compensation - will reduce their work load regarding derivatives calculations relative to the current regime and the IRS would have the ability to check tax values for mark to market against values reported for those other purposes.

Hedging exception

The proposal includes an exception to the mark to market requirement for derivatives transactions that qualify as business hedges, those transactions that manage risks related to ordinary property or ordinary obligations and identified as a hedge before the close of the day on which the taxpayer entered into the transaction. Current hedging regulations under section 1221 provide that the identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy this requirement unless the taxpayer's books and records indicate that the identification also is being made for tax purposes. The President's proposal reverses this rule and allows taxpayers to satisfy the tax hedge identification requirement by identifying the transaction as a business hedge for financial accounting purposes only.

Financial accounting defines a hedging transaction entirely differently from the tax law because the purpose of the accounting and tax hedging regimes are different. Financial accounting has a general goal to mark all derivatives to market and provides a hedging exception to allow business to match income from a derivative used as a hedge with income from the item being hedged, and adjusting recognition of the two income flows accordingly. In contrast, the current tax rules for hedging developed from longstanding controversy over the character of income (particularly losses) flowing from derivatives used as hedges. The current statutory tax hedging regime requires that taxpayers treat income and loss from derivatives used as hedges as ordinary income and loss. In addition, Treasury regulations require that timing of income and loss on a hedge be matched with the timing of income on the item being hedged. Same-day identification of a transaction as a tax hedge ensures that taxpayers do not cherry pick the treatment of their derivatives depending on the transaction's ultimate outcome (gain or loss).

Given the different purposes of the hedge regimes for accounting and tax purposes, it is hard to see how an accounting identification protects the fisc. Taxpayers identify many transactions as accounting hedges that can never be tax hedges, the identification creates in effect an elective regime in which taxpayers are free to claim transactions are or are not hedges depending on whether they generate gain or loss. They might disclose their accounting identifications to the IRS when advantageous and announce them as "only for book" otherwise. This places the fisc in a vulnerable position.

Providing an exception to derivative mark to market treatment through the hedging regime raises a broader question about the policy behind the regime, and the opportunity to reconsider its scope. As mentioned, a primary purpose in enacting the current hedging regime was to provide relief from capital treatment of losses from derivatives, that is, it had a character focus. But because the derivative regime under the proposal makes all income flowing from derivatives ordinary, under the proposal hedging is a timing exception only. Derivatives will give rise to ordinary income or expense irrespective of whether they are hedges or not. Both

legislation and regulations may want to reconsider the definition of hedge because of the change of focus, and perhaps look more closely at the financial accounting hedging regime which also has a measurement and timing of income focus.

Straddles

The most significant change from the prior year's proposal to this year's proposal is in the treatment of straddles. Straddles constituted by stock and a derivative causes the stock in the straddle to be marked to market. The proposal is silent as to the character of the mark for the stock when entering into the straddle and thereafter. Assuming, therefore, that current law governs, the mark on the stock has a capital character. This results in a mismatch of the ordinary character of the mark to market on the derivative and capital character of the stock.

No capital assets other than stock are subject to the straddle mark to market rule. Because it is not stated how current statutory rules for straddles would be amended as a result of the derivative mark to market proposal, it is unclear how the proposal intends to police straddle abuses. It is also unclear why debt has been omitted from the proposal's straddle regime; it would appear that the same reasons for applying mark to market to stock that is a capital asset within a straddle also applies to debt.

In addition, the proposal provides the Secretary authority to issue regulations matching the various tax characteristics of a capital asset with a transaction that "diminishes the risk of loss" or opportunity for gain from the asset. The language proposed is different from the current statutory definition of straddles that requires a "substantial diminution" of risk of loss and so the ambit of the proposed regulatory authority is potentially wider than what is currently be called a straddle.

The proposal does not provide any indication of the policy that such matching regulations for straddle-like transactions would implement over such a wide swath of tax characteristics: timing, source, and character. Nor does it describe why such authority should be granted rather than the creation by Congress of a statutory regime that implements Congressional policy after due deliberation.

B. Modify Rules that Apply to Sales of Life Insurance Contracts

Description of Modification

The fiscal year 2015 budget proposal modifies the prior year budget proposal by adding a reporting requirement upon the payment of benefits under the acquired policy.[318] Upon the payment of policy benefits to the acquirer, the modified proposal requires the insurance company

[318] The prior year budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCX-2-12), June 2012, pp. 459-463. The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), Item VI. B., reprinted in the back of this volume.

to report the gross amount of the benefit payment, the acquirer's taxpayer identification number ("TIN"), and the insurance company's estimate of the buyer's basis to the IRS and to the payee.

The fiscal year 2015 budget proposal further modifies the prior year budget proposal by eliminating certain exceptions to the present-law transfer for value rule and substituting an exception in the case of a transfer of a policy to the insured, or to a partnership or a corporation of which the insured is a 20-percent owner. The exceptions eliminated are those present-law exceptions that apply if the transfer is to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer. Other present-law exceptions (if the transferred policy has a carryover basis in whole or part, or if the transfer is to the insured) are retained under the proposal.

C. Modify Proration Rules for Life Insurance Company General and Separate Accounts

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 464-474. The estimated budget effects of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VI.C, reprinted in the back of this volume.

D. Expand Pro Rata Interest Expense Disallowance for Corporate-Owned Life Insurance

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 475-480. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VI.D, reprinted in the back of this volume.

PART VII − ELIMINATE FOSSIL FUEL PREFERENCES

A. Eliminate Oil and Natural Gas Preferences

1. Repeal enhanced oil recovery credit

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 481-505. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VII.A.1, reprinted in the back of this volume.

2. Repeal credit for oil and natural gas produced from marginal wells

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 481-505. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VII.A.2, reprinted in the back of this volume.

3. Repeal expensing of intangible drilling costs

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 481-505. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VII.A.3, reprinted in the back of this volume.

4. Repeal deduction for tertiary injectants

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 481-505. The estimated budgetary effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VII.A.4, reprinted in the back of this volume.

5. Repeal exception to passive loss limitation for working interests in oil and natural gas properties

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 481-505. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VII.A.5, reprinted in the back of this volume.

6. Repeal percentage depletion for oil and natural gas properties

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 481-505. The estimated budgetary effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VII.A.6, reprinted in the back of this volume.

7. Repeal domestic manufacturing deduction for oil and natural gas production

This proposal is substantially similar to a proposal found in last year's budget proposal. Last year's proposal was a modification of the prior year's proposal. That modification is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 47, and the original proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 88-96. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VII.A.7, reprinted in the back of this volume.

8. Increase geological and geophysical amortization period for independent producers to seven years

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 481-505. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VII.A.8, reprinted in the back of this volume.

B. Eliminate Coal Preferences

1. Repeal expensing of exploration and development costs

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 481-505. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VII.B.1, reprinted in the back of this volume.

2. Repeal percentage depletion for hard mineral fossil fuels

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 481-505. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VII.B.2, reprinted in the back of this volume.

3. Repeal capital gains treatment for royalties

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 481-505. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VII.B.3, reprinted in the back of this volume.

4. Repeal domestic manufacturing deduction for the production of coal and other hard mineral fossil fuels

This proposal is substantially similar to a proposal found in last year's budget proposal. Last year's proposal was a modification of the prior year's proposal. That modification is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 48, and the original proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 88-96. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VII.B.4, reprinted in the back of this volume.

PART VIII − OTHER REVENUE CHANGES AND LOOPHOLE CLOSERS

A. Repeal the Excise Tax Credit for Distilled Spirits with Flavor and Wine Additives

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 49-52. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VIII.A, reprinted in the back of this volume.

B. Repeal Last-In, First-Out (LIFO) Method of Accounting for Inventories

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 516-520. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VIII.B, reprinted in the back of this volume.

C. Repeal Lower-Of-Cost-Or-Market (LCM) Inventory Accounting Method

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 521-522. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VIII.C, reprinted in the back of this volume.

D. Modify Depreciation Rules for Purchases of General Aviation Passenger Aircraft

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 523-524. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VIII.D, reprinted in the back of this volume.

E. Repeal Gain Limitation for Dividends Received in Reorganization Exchanges

Description of Modification

The fiscal year 2014 budget proposal is modified by adding that the proposal would take into account all of the available earnings and profits of the corporation (not merely the shareholder's ratable share of the corporation's undistributed earnings and profits) consistent with the rules governing ordinary dividend distributions.[319] The proposal and modification are effective for taxable years beginning after December 31, 2012.

Analysis

The proposal is clear in its intent to repeal the boot-within-gain limitation, and repeals the "ratable share" language that may provide a greater limitation on reorganization dividend treatment than would exist in the case of a direct dividend.

Another issue that may require clarification is the source of the accumulated earnings and profits from which the deemed dividend is generated under section 356(a)(2). As discussed in the analysis of the fiscal year 2013 proposal, conflicting positions exist under present law as to whether the accumulated earnings and profits taken into account should be that of both the transferor and acquiring corporation or, instead, should be limited to only that of the transferor corporation. The proposal appears to look only to the transferor corporation. To the extent that the boot-within-gain limitation rule is repealed, it will create more scenarios in which the boot amount will exceed the accumulated earnings and profits of either the transferor or acquiring corporation on a stand-alone basis. Therefore, additional guidance may be necessary to determine the source of any deemed dividend under section 356(a)(2). One possible alternative would be to adopt a rule similar to that which applies to boot received in an intercompany reorganizations within a consolidated group that would otherwise be covered under section 356(a)(2).[320] Such a rule would require that the boot be taken into account after completion of

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[319] The President's fiscal year 2010 budget proposal was similar, but was limited to asset reorganizations involving a foreign acquiring corporation. The fiscal year 2010 proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal, Part III: Provisions Related to the Taxation of Cross-Border Income and Investment* (JCS-4-09), September 2009, p. 115. The President's fiscal year 2011, 2012, and 2013 proposals applied without regard to whether there was a foreign acquiring corporation. The fiscal year 2011 proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal* (JCS-2-10), August 16, 2010, p. 193. The fiscal year 2012 proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal* (JCS-3-11), June 2011, p. 304. The fiscal year 2013 proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 527.

The estimated budgetary effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VIII.E, reprinted at the back of this volume.

[320] Treas. Reg. sec. 1.1502-13(f).

the reorganization which would be based on the combined earnings and profits of the acquiring corporation and target corporation.[321]

In addition, as discussed in the analysis of the fiscal year 2013 proposal, there is a potential lack of clarity under present law whether a reference to "earnings and profits accumulated" includes current earnings and profits for the year of the distribution. Additional guidance may be desirable regarding this issue.

Finally, it can be argued that, while the repeal of the boot-within-gain limitation when there is a foreign acquiring corporation will limit the ability of taxpayers to repatriate earnings with little or no tax, the repeal may have other unintended consequences that may be used affirmatively by taxpayers for planning purposes. By way of example, section 304 was enacted to prevent what were deemed to be abusive transactions by taxpayers to convert what would otherwise be dividends into capital gain transactions. Today, taxpayers typically trigger section 304 only when they are affirmatively using it for foreign tax credit and cash repatriation planning purposes. Depending on the manner in which the repeal of the boot-within-gain limitation rule is implemented, it may be expected that similar tax planning opportunities will arise (*e.g.*, if the earnings and profits sourcing and ordering rules differ from those under section 304). To the extent that economically similar transactions can be constructed either as a direct dividend or, alternatively, as a reorganization or as a section 304 transaction, it can be argued that it is desirable to conform the results.

[321] The proposal does not limit the situations to which it applies only to those of entirely common ownership. Compare Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, Volume II: Recommendations of the staff of the Joint Committee on Taxation to Simplify the Federal Tax System*, (JCS-3-01) 2001, pp. 267-68 (2001), recommending a similar proposal but only for certain types of reorganizations. However, the proposal is arguably further simplifying in applying the same rules to all cases in which an exchange has the effect of a dividend. Looking to the earnings and profits of both companies would arguably be consistent with the approach of *Clark v. Commissioner, supra,* which measured the deemed redemption for dividend equivalence on the basis of the stock that would have been owned by a shareholder in the combined corporations after the reorganization.

F. Expand the Definition of Substantial Built-In Loss for Purposes of Partnership Loss Transfers

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 553-555. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VIII.F, reprinted in the back of this volume.

G. Extend the Partnership Basis Limitation Rules to Nondeductible Expenditures

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 556-558. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VIII.G, reprinted in the back of this volume.

H. Limit the Importation of Losses Under Related Party Loss Limitation Rules

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 559-561. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VIII.H, reprinted in the back of this volume.

I. Deny Deduction for Punitive Damages

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 562-564. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VIII.I, reprinted in the back of this volume.

J. Modify Like-Kind Exchange Rules for Real Property

Present Law

An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like-kind" which is to be held for productive use in a trade or business or for investment.[322] In general, section 1031 does not apply to any exchange of stock in trade (*i.e.*, inventory) or other property held primarily for sale; stocks, bonds or notes; other securities or evidences of indebtedness or interest; interests in a partnership; certificates of trust or beneficial interests; or choses in action.[323] Section 1031 also does not apply to certain exchanges involving livestock[324] or foreign property.[325]

For purposes of section 1031, the determination of "like-kind" relates to the nature or character of the property and not its grade or quality, *i.e.*, the nonrecognition rules do not apply to an exchange of one class or kind of property for property of a different class or kind (*e.g.*, section 1031 does not apply to an exchange of real property for personal property).[326] The different classes of property are: (1) depreciable tangible personal property;[327] (2) intangible or nondepreciable personal property;[328] and (3) real property.[329] However, the rules with respect to whether real estate is "like-kind" are applied more liberally than the rules governing like-kind exchanges of depreciable, intangible, or nondepreciable personal property. For example, improved real estate and unimproved real estate generally are considered to be property of a "like-kind" as this distinction relates to the grade or quality of the real estate,[330] while

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[322] Sec. 1031(a)(1).

[323] Sec. 1031(a)(2).

[324] Sec. 1031(e).

[325] Sec. 1031(h).

[326] Treas. Reg. sec. 1.1031(a)-1(b).

[327] For example, an exchange of a personal computer classified under asset class 00.12 of Rev. Proc. 87-56, 1987-2 C.B. 674, for a printer classified under the same asset class of Rev. Proc. 87-56 would be treated as property of a like-kind. However, an exchange of an airplane classified under asset class 00.21 of Rev. Proc. 87-56 for a heavy general purpose truck classified under asset class 00.242 of Rev. Proc. 87-56 would not be treated as property of a like-kind. See Treas. Reg. sec. 1.1031(a)-2(b)(7).

[328] For example, an exchange of a copyright on a novel for a copyright on a different novel would be treated as property of a like-kind. See Treas. Reg. sec. 1.1031(a)-2(c)(3). However, under Treas. Reg. sec. 1.1031(a)-2(c)(2), the goodwill or going concern value of one business is not property of a like-kind to the goodwill or going concern value of a different business. The Internal Revenue Service ("IRS") has ruled that intangible assets such as trademarks, trade names, mastheads, and customer-based intangibles that can be separately described and valued apart from goodwill qualify as property of a like-kind under section 1031. See Chief Counsel Advice 200911006, February 12, 2009.

[329] Treas. Reg. sec. 1.1031(a)-1(b) and (c).

depreciable tangible personal properties must be either within the same General Asset Class[331] or within the same Product Class.[332]

The nonrecognition of gain in a like-kind exchange applies only to the extent that like-kind property is received in the exchange. Thus, if an exchange of property would meet the requirements of section 1031, but for the fact that the property received in the transaction consists not only of the property that would be permitted to be exchanged on a tax-free basis, but also other non-qualifying property or money ("additional consideration"), then the gain to the recipient of the other property or money is required to be recognized, but not in an amount exceeding the fair market value of such other property or money.[333] Additionally, any such gain realized on a section 1031 exchange as a result of additional consideration being involved constitutes ordinary income to the extent that the gain is subject to the recapture provisions of sections 1245 and 1250.[334] No losses may be recognized from a like-kind exchange.[335]

If section 1031 applies to an exchange of properties, the basis of the property received in the exchange is equal to the basis of the property transferred. This basis is increased to the

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[330] Treas. Reg. sec. 1.1031(a)-1(b).

[331] Treasury Regulation section 1.1031(a)-2(b)(2) provides the following list of General Asset Classes, based on asset classes 00.11 through 00.28 and 00.4 of Rev. Proc. 87-56, 1987-2 C.B. 674: (i) Office furniture, fixtures, and equipment (asset class 00.11), (ii) Information systems (computers and peripheral equipment) (asset class 00.12), (iii) Data handling equipment, except computers (asset class 00.13), (iv) Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21), (v) Automobiles, taxis (asset class 00.22), (vi) Buses (asset class 00.23), (vii) Light general purpose trucks (asset class 00.241), (viii) Heavy general purpose trucks (asset class 00.242), (ix) Railroad cars and locomotives, except those owned by railroad transportation companies (asset class 00.25), (x) Tractor units for use over-the-road (asset class 00.26), (xi) Trailers and trailer-mounted containers (asset class 00.27), (xii) Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction (asset class 00.28), and (xiii) Industrial steam and electric generation and/or distribution systems (asset class 00.4).

[332] Property within a product class consists of depreciable tangible personal property that is described in a 6-digit product class within Sectors 31, 32, and 33 (pertaining to manufacturing industries) of the North American Industry Classification System ("NAICS"), set forth in Executive Office of the President, Office of Management and Budget, *North American Industry Classification System*, United States, 2002 (NAICS Manual), as periodically updated. Treas. Reg. sec. 1.1031(a)-2(b)(3).

[333] Sec. 1031(b). For example, if a taxpayer holding land A having a basis of $40,000 and a fair market value of $100,000 exchanges the property for land B worth $90,000 plus $10,000 in cash, the taxpayer would recognize $10,000 of gain on the transaction, which would be includable in income. The remaining $50,000 of gain would be deferred until the taxpayer disposes of land B in a taxable sale or exchange.

[334] Secs. 1245(b)(4) and 1250(d)(4). For example, if a taxpayer holding section 1245 property A with an original cost basis of $11,000, an adjusted basis of $10,000, and a fair market value of $15,000 exchanges the property for section 1245 property B with a fair market value of $14,000 plus $1,000 in cash, the taxpayer would recognize $1,000 of ordinary income on the transaction. The remaining $4,000 of gain would be deferred until the taxpayer disposes of section 1245 property B in a taxable sale or exchange.

[335] Sec. 1031(c).

extent of any gain recognized due to the receipt of other property or money in the like-kind exchange, and decreased to the extent of any money received by the taxpayer.[336] The holding period of qualifying property received includes the holding period of the qualifying property transferred, but the nonqualifying property received is required to begin a new holding period.[337]

A like-kind exchange also does not require that the properties be exchanged simultaneously. Rather, the Code requires that the property to be received in the exchange be received not more than 180 days after the date on which the taxpayer relinquishes the original property (but in no event later than the due date (including extensions) of the taxpayer's income tax return for the taxable year in which the transfer of the relinquished property occurs).[338] In addition, the taxpayer must identify the property to be received within 45 days after the date on which the taxpayer transfers the property relinquished in the exchange.[339]

The Treasury Department has issued regulations[340] providing guidance and safe harbors for taxpayers engaging in deferred like-kind exchanges. These regulations allow a taxpayer who wishes to sell appreciated property and reinvest the proceeds in other like-kind property to engage in three-way exchanges.[341] In order for a three-way exchange to qualify for tax-free treatment, the regulations prescribe detailed rules regarding identification of the replacement property, rules allowing the seller to receive security for performance by the buyer without the seller being in receipt of money or other property, and rules relating to whether a person is an agent of the taxpayer or is a qualified intermediary whose receipt of money or other property is not attributed to the taxpayer.

In addition, the IRS has released a revenue procedure[342] providing that if certain formulaic requirements are satisfied, the IRS will not challenge deferred exchanges where the

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[336] Sec. 1031(d). Thus, in the example noted above, the taxpayer's basis in B would be $40,000 (the taxpayer's transferred basis of $40,000, increased by $10,000 in gain recognized, and decreased by $10,000 in money received).

[337] Sec. 1223(1).

[338] Sec. 1031(a)(3).

[339] *Ibid.*

[340] Treas. Reg. sec. 1.1031(k)-1(a) through (o).

[341] For example, if taxpayer A wishes to sell his appreciated apartment building and acquire a commercial building, taxpayer A may transfer his apartment building to buyer B. Buyer B (directly or through an intermediary) agrees to purchase from owner C the commercial building that taxpayer A has designated. Buyer B then transfers title to the newly acquired commercial building to taxpayer A, completing the tax-free like-kind exchange. The economics of these transactions (taxes aside) are the same as if taxpayer A had sold the apartment building to buyer B and used the proceeds to purchase the commercial building from owner C. However, a transaction in which the taxpayer receives the proceeds of the sale and subsequently purchases like-kind property would be taxable to such taxpayer under general tax principles.

[342] Rev. Proc. 2000-37, 2000-40 I.R.B. 308.

replacement property is acquired prior to the disposition of the relinquished property.[343] The revenue procedure provides that the taxpayer will not be considered the owner of the property, for purposes of determining if the property qualifies as replacement property under section 1031, so long as the taxpayer satisfies the stated requirements of the revenue procedure. This treatment is irrespective of whether general tax principles would consider the taxpayer as the owner of the property for federal income tax purposes.

The rules prescribed in the regulations and the revenue procedure provide safe harbors that allow taxpayers to comply with the exchange requirement of present law. However, these rules are quite complicated and the failure to comply may result in a taxable transaction. Additionally, these rules impose compliance burdens and additional costs to taxpayers.

Description of Proposal

The proposal modifies the provision providing for nonrecognition of gain in the case of like-kind exchanges by limiting the amount of capital gain deferred on the exchange of real property to $1,000,000 (indexed for inflation) per taxpayer per taxable year.[344] The proposal also grants the Secretary of the Treasury authority to prescribe Treasury Regulations necessary to carry out the provision, including guidance on the aggregation of multiple properties exchanged by related parties.

Effective date.−The proposal applies to like-kind exchanges of real property completed after December 31, 2014.

Analysis

The concept of gain deferral when like-kind property is exchanged has been in place for nearly 100 years. Originally enacted in the Revenue Act of 1921,[345] the like-kind exchange provisions have remained largely unchanged since the early 1920's. However, a few notable revisions were included in the Tax Reform Act of 1984,[346] which added the provisions generally requiring qualifying property to be identified within 45 days and exchanged within 180 days;[347]

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[343] The preamble to the 1991 final regulations under section 1031 stated that regulations would not be applicable to exchanges where the replacement property is acquired prior to the disposition of the relinquished property. T.D. 8346, 1991-1 C.B. 150.

[344] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), Item VIII.J., reprinted in the back of this volume.

[345] Pub. L. No. 67-98. The predecessor to section 1031 (section 202 of the Revenue Act of 1921) was originally enacted in response to the administrative burden of having to value horse trades and similar barter transactions for tax purposes. See *Godine v. Commissioner*, T.C. Memo 1977-393, citing H.R. Rep. No. 704, 73d Cong. 2d Sess. (1934).

[346] Pub. L. No. 98-369.

[347] This requirement was added by Congress in response to *Starker v. United* States, 602 F. 2d 1341 (9th Cir. 1979), wherein the court allowed a five-year period to acquire replacement property.

the Omnibus Budget Reconciliation Act of 1989,[348] which added rules preventing certain related party exchange transactions to be used to avoid gain recognition; and the Heartland, Habitat, Harvest, and Horticulture Act of 2008,[349] which provided that shares in a mutual ditch, reservoir, or irrigation company are not "shares" for purposes of property excepted from section 1031. The definition of like-kind property has been modified legislatively to address issues relating to targeted types of property.

Some may argue that the Administration's proposal to limit gain deferral under section 1031 disrupts nearly 100 years of settled tax policy. On the other hand, fundamental income tax principles might suggest that deferral of gains on exchanges of real estate or other like-kind property mismeasures income and fails to account properly for accretions to wealth. It could be said that the concept of like-kind property does not justify the taxpayer's ability to dispose of property and acquire different property without paying tax on the transaction. Those concerned about income mismeasurement under the current rules for deferral of gain on like-kind exchanges might argue that, if there is little tax policy justification for the present-law rule, then imposing a dollar limitation on the benefit serves to moderate the economic distortions to which the current provision gives rise.

Some may contend that requiring gain recognition under the proposal will require valuation and may result in valuation disputes. Supporters of the proposal might respond, however, that in many cases valuation may not be difficult. For example, present law permits cash consideration that enables valuation in the case of cash held by intermediaries for the purchase of replacement property, or in the case of cash provided by the transferor to purchase new business property in an exchange for the old business property. The potential for valuation disputes is also reduced because the proposal retains nonrecognition treatment for loss property.

Some may also contend that the Administration's proposal reduces the incentive to hold real property for productive use in the taxpayer's trade or business, or to hold real property for investment purposes. By limiting section 1031 and a taxpayer's ability to defer the recognition of gain on the disposition of such property if it is exchanged for property of a like-kind, the proposal reduces the after-tax rate of return to investments in section 1031 property (*i.e.*, the proposal has the effects of taxing the appreciation of certain real property before the taxpayer has fully disposed of its investment in real property, resulting in increased taxes on real property). However, others might argue that tax incentives favoring disposition are not needed to encourage the holding of property, whether for business or investment purposes. Further, tax incentives for disposing of certain types of property can create tax-induced economic distortions as compared to less tax-favored assets.

Some may contend that the proposal deters taxpayers from entering into like-kind exchanges of highly-appreciated real property, as well as from engaging in complicated exchanges designed to meet the statutory and regulatory rules regarding deferred exchanges. Guidance would have to be developed to implement the application of the proposal in complex

[348] Pub. L. No. 101-239.

[349] Title XV of the Food, Conservation, and Energy Act of 2008, Pub. L. No. 110-234.

fact situations. Further, because the limitation applies to like-kind exchanges after December 31, 2014, regardless of when the taxpayer initially acquired the real property, taxpayers' long-term investment strategies could be upset and consideration of transition relief may be warranted during any process of enactment of the proposal.

Under the proposal, capital gain is recognized to the extent the taxpayer's total capital gains on like-kind exchanges of real property exceed $1,000,000 (indexed for inflation) for the taxable year. For example, assume a calendar year taxpayer on October 1, 2015, sells investment land A for $2,000,000 with a basis of $800,000, and purchases investment land B for $1,900,000 on December 1, 2015. The taxpayer is required to recognize $200,000 of gain on October 1, 2015 ($2,000,000 sales proceeds - $800,000 basis - $1,000,000 limitation). The remaining $1,000,000 of gain is deferred until the taxpayer disposes of land B in a taxable sale or exchange. Present-law section 1031 only requires the taxpayer to recognize $100,000 of gain on October 1, 2015 ($2,000,000 sales proceeds - $1,900,000 cost of replacement property), and permits the taxpayer to defer the remaining $1,100,000 of gain ($1,900,000 cost of land B - $800,000 basis of land A) until it disposes of land B in a taxable sale or exchange. In the absence of section 1031, the taxpayer in the previous example recognizes $1,200,000 of gain on October 1, 2015 ($2,000,000 sales proceeds - $800,000 basis in land A), and has basis in land B of $1,900,000.

For taxpayers with capital gain of less than $1,000,000 from the sale of section 1031 property, there is no change from present law. Under the proposal, the entire amount of the gain is deferred. Thus the proposal is beneficial for real estate exchanges with relatively small amounts of gain (regardless of the size of the transaction) relative to exchanges of property with more appreciation. From a distributional policy perspective, generally limiting the applicability of section 1031 to like-kind exchanges undertaken by small businesses and investors in the case of real estate transactions may be the desired result. However, the proposal targets small amounts of gain rather than characteristics of the taxpayers undertaking the exchanges. Further, the proposal does not specify to whom the application of the dollar limitation applies in the case of exchanges by partnerships or S corporations (*i.e.*, the entity or the owners). Presumably any Treasury Regulations issued should provide attribution rules necessary to implement the $1,000,000 per taxpayer rule.

There is no change from present law under the proposal for like-kind exchanges of depreciable tangible personal property or intangible personal property. Under section 1031, tangible personal property must be exchanged for property of a like kind or a like class (*e.g.*, the exchange of an airplane for a truck would not constitute a like-kind exchange even though both assets constitute tangible personal property). Similarly, intangible personal property must be exchanged for property of a like nature or character (*e.g.*, the exchange of a copyright on a novel for a copyright on a song would not constitute a like-kind exchange even though both assets are copyrights). Conversely, improved real estate may be exchanged for unimproved real estate and qualify under section 1031. Thus, the proposal is likely targeted at, in part, exchanges of unimproved real estate for improved real estate.

K. Conform Corporate Ownership Standards

Present Law

The ability to engage in certain corporate transactions in a tax-free manner (such as an incorporation, distribution, or a reorganization) often depends upon satisfaction of a "control" test. For these purposes, the term "control" is defined, in section 368(c), as the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

On the other hand, for purposes of determining whether two corporations are sufficiently affiliated so that, in essence, they are treated as a single corporation for some tax purposes (such as the filing of a consolidated return,[350] tax-free liquidations of a subsidiary into a parent corporation,[351] and qualified stock purchases that can be treated as if the assets rather than stock of a corporation were acquired),[352] the relevant ownership test requires at least 80 percent of the total voting power of the corporation's stock and at least 80 percent of the total value of the corporation's stock (sec. 1504(a)(2).[353] For this purpose, stock does not include preferred stock that meets the requirements of section 1504(a)(4).[354]

Description of Proposal

The proposal would conform the control test under section 368(c) with the affiliation test under section 1504(a)(2).[355] Thus, "control" would be defined as the ownership of at least 80

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[350] Sec. 1504.

[351] Sec. 332(b)(1).

[352] Sec. 338(d)(3).

[353] The section 1504 control test is also used for some purposes in determining whether a distributing or controlled corporation satisfies the 5-year active business requirement for a tax-free spin-off under section 355. Whether either such corporation satisfies that test is generally determined on the basis of business conducted by members of each corporation's respective "separate affiliated groups." Sec. 355(b)(3). However, if either distributing or controlled corporation is a mere holding company, then the active business of a corporation that is immediately controlled (under section 368(c)) by that corporation can be used to satisfy the requirement, (again, however, using section 1504 principles with respect to that immediate 368(c) subsidiary).

[354] Stock that meets the requirements of section 1504(a)(4) is stock that (A) is not entitled to vote, (B) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (C) has redemption and liquidation rights which to not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), and (D) is not convertible into another class of stock. Such stock is sometimes referred to as "pure preferred stock."

[355] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, item VIII.K, reprinted in the back of this volume. The President's fiscal year budget proposal for 2000 contained a proposal identical to the current proposal and the President's fiscal year budget proposal for 2001 contained a similar proposal with additional language regarding "direct or indirect" ownership that would look

percent of the total voting power and at least 80 percent of the total value of the stock of a corporation. For this purpose, stock would not include preferred stock that meets the requirements of section 1504(a)(4).

Effective date.−The proposal would be effective for transactions on or after the date of enactment.

Analysis

In general

The proposal would impose tighter rules with respect to tax-free separations of corporate business, and would reduce the ability to engage in tax-free transactions with "sales-like" characteristics.

Corporate equity structures can be created that separate the voting power from the value of stock (*e.g.*, one class of common stock is heavy vote-light value stock, and another class is light vote-heavy value). This separation of vote from value may permit a party to satisfy the "control" test for incorporations, distributions, or reorganizations through voting power. Also, it may permit the tax-free disposition of much of the value of the common stock and future growth of a corporation.

One type of transaction in which such disproportionate equity structures have been used is a tax-free separation of corporate business through a spin-off.[356] A distributing corporation must "control" a subsidiary at the time of the spin-off to qualify for tax-free treatment. In some cases, where one corporation owns a non-controlling stock interest in another and the parties wish to eliminate this cross ownership, the corporation whose stock is owned has been recapitalized to give the required 80 percent of the vote to the corporation that desires to make a tax-free distribution. The IRS has ruled that such a pre-spin-off recapitalization is respected so long as it effects a "permanent realignment" of the stock ownership. 357

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through chains of 80 percent controlled entities and consider lower tiers to be 80 percent owned if so owned by their direct owners. The fiscal year 2000 proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal* (JCS-1-99), February 22, 1999, p. 220. The fiscal year 2001 proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal* (JCS-2-00), March 6, 2000, p. 363.

[356] The term "spin-off" is used as a broad description encompassing the various types of tax-free corporate divisive transactions under section 355, including "split offs" (in which shareholders surrender stock of distributing corporation and acquire stock of controlled corporations) and "split-ups" (in which shareholders surrender stock of distributing corporation, which distributes different subsidiaries to different shareholders and ceases to exist as an entity).

[357] Rev. Rul. 69-407, 1969-2 C.B. 50. *Compare* Rev. Rul. 63-260, 1963-2 C.B. 147, in which the corporation did not recapitalize; rather, a 30-percent shareholder of a corporation contributed, to corporation that owned the other 70-percent, 10 percent of the corporate stock in an attempt to satisfy the control requirement as part of a plan to spin off the 80-percent subsidiary. The ruling concluded that the control test was not satisfied because X did not have "control" of Y within the meaning of section 368(c) of the Code immediately before the distribution

In other cases, distributing corporations have recapitalized subsidiaries prior to a spin-off such that the parent disposes of significant stock value prior to the spin-off through the issuance of "light vote" stock. The distributing parent corporation may retain the proceeds of such a stock issuance as tax-free cash.[358] A planned disposition of more than 50 percent of the value of corporate stock (including for this purpose stock that meets the requirements of section 1504(a)(4)), in connection with a spin-off, would invoke corporate level gain recognition on the distribution under section 355(e). The ability to dispose of value prior to a spin-off is thus relevant for stock dispositions of between 20 to 50 percent of stock value.

It has been observed that after a recapitalization and spin-off, the low vote (but high value) common stock trades at a premium to the high vote (but low value) stock; and the board of directors frequently recommends, and shareholders vote, to unwind the recapitalization and conform the rights of the two groups.[359] The IRS has, in various private rulings,[360] permitted such post-spin-off realignments, provided there were representations that they were not planned and that a separate vote was necessary after the spin-off to accomplish them. However, in 2003, the IRS stated that it would not ordinarily issue a supplemental ruling addressing a post-spin-off realignment.[361] In 2013, the IRS ceased to provide private rulings on questions of recapitalizations prior to a spin off, stating that the area is under study.[362]

Light vote-heavy value stock also has been used in connection with certain reorganizations that the IRS has challenged as more similar to a taxable sale.[363] The putative

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except in a transitory and illusory sense. It stated that Section 355 of the Code cannot be made to apply to a transaction in which an immediately preceding contribution to capital by the distributor corporation's shareholder is made solely to attempt to qualify the transaction as a nontaxable distribution under that section.

[358] See, *e.g.*, Sloan, "Corporations' Last-Minute Lunge For an Obscure Tax Loophole," The Washington Post (July 6, 1999), C-3; Sisk, "Conoco Deal Seen Legitimizing Spinoff Tax Technique," Corporate Financing Week, Vol. XXIV, No. 46 (November 16, 1998). The Sloan article refers to the President's fiscal year 2000 budget proposal, which was not enacted.

[359] See, Thomas F. Wessel, Joseph M. Pari, and Richard D'Avino, "Corporate Distributions under Section 355", at pp. 555-557*,* in *Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings,* Practising Law Institute, October, 2012*.*

[360] See, *e.g.*, PLR 199935031 (June 2, 1999), supplemented by PLR 200403041 (October 8, 2003. A private letter ruling cannot be relied upon by a taxpayer other than the taxpayer to which it is issued; however private letter rulings provide some indication of IRS administrative practice.

[361] Rev. Proc. 2003-48, 2003-1 C.B. 863, Sec. 4.06.

[362] Rev. Proc. 2013-3, 2013-1 I.R.B. 113, sec. 5.01(9).

[363] See, *e.g.*, Sheppard, "Corporate Sales: Ignore that LLC behind the Curtain," 82 Tax Notes 32 (January 4, 1999). The IRS challenged the case discussed in the article. In *Tribune Co. v. Commissioner,* 125 T.C. 110 (2005), the Tax Court concluded that the Tribune corporation had received non-qualified "boot" consideration in the form of its right to control the LLC, in an amount sufficient to disqualify the reorganization.

seller transfers appreciated property in exchange for a stock interest that shares in little, if any, of the economic growth potential of the property it formerly owned--the growth potential now belongs to the other party to the transaction (the buyer). Instead, the seller's stock interest reflects the economic value of property (including cash) contributed by the buyer as part of the transaction.

The evolution of the 1504 control test

Adopting the more tightened definition of control under the proposal might be viewed as comparable to the history of the affiliation test under section 1504(a). Prior to 1984, the affiliation test required an ownership of 80 percent of the voting power and 80 percent of each class of the nonvoting stock of each includible corporation. In the Deficit Reduction Act of 1984[364], Congress amended section 1504(a) to include an 80-percent value test, in part because "notwithstanding the intent of the provision, corporations were filing consolidated returns under circumstances in which a parent corporation's interest in the issuing corporation accounted for less than 80 percent of the real equity value of such corporation."[365] For example, by allowing such consolidations, losses of one entity could in effect be offset against income of another profitable entity through the consolidated return, under circumstances that Congress believed were insufficiently related.

In 1984, Congress did not amend the section 368(c) control test. Commentators have differed in their views of whether or not the two tests serve sufficiently different purposes to justify different standards. [366]

On Oct. 1, 2007, the Company announced that it had finalized the settlement of its appeal of the 2005 Tax Court decision disallowing the tax-free reorganizations. See footnote 4 to financial statements at http://www.sec.gov/Archives/edgar/data/726513/000072651307000050/exhibit99.htm

Some commentators have expressed the view that the Tax Court's analysis "hardly seems free from doubt." Martin D. Ginsburg, Jack S. Levin, and Donald E. Rocap, *Mergers, Acquisitions, and Buyouts,* Wolters Kluwer, 2013, Par. 803, at 8-56.

[364] Pub. L. No. 98-369.

[365] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, 170-171.

[366] See, American Bar Association Section of Taxation, Comments on Proposed Change to Section 368(c) Definition of Corporate Control, 1999 TNT 68-24, at 7 (April 7, 1999) ("The analogy [between the 1984 change to the section 1504 control test and the proposal] is not appropriate, however, because the policies underlying the control requirement in a consolidated return context call for a stricter definition of control than do the policies for the control requirement in section 368."). Cf. New York State Bar Association Tax Section, "Report on Proposal to Amend the Control Test in Section 368(c)," 1999 TNT 135-28 (July 9, 1999) (majority supports inclusion of an 80 percent value standard for purposes of the section 368(c) control test; a significant minority believes that less unity should be required to avoid a recognition event in an incorporation or reorganization transaction than should be required to treat two taxpayers as one under section 1504). In 1985, the staff of the Senate Finance Committee recommended amending the control test to conform with the new affiliation test. See, Senate Finance Committee Staff Report, The Subchapter C Revision Act of 1985, S. Print 99-47, 99th Cong., 1st Sess. (1985), proposed section 366(c).

Pure preferred stock or debt

By adopting the section 1504 test for control, the proposal permits pure preferred stock (section 1504(a)(4) stock) to be ignored in determining whether the 80 percent value test is satisfied. Some might question whether such pure preferred stock might in the future be used as a substitute for low-vote, high-value stock, thus limiting the effect of the proposal.[367] In addition, debt can still be issued without affecting the control requirement.

For example, in the context of a spin-off, a corporation might raise funds of up to 50 percent of the value of subsidiary prior to a spin-off, by issuing pure preferred stock. Debt might also be issued. However, pure preferred stock cannot have any vote, and must not be expected to participate in future corporate growth to any significant extent. The appetite of investors for such stock might be more limited than for stock having a growth potential. The issues relating to the use of debt are similar. In addition, it might be undesirable or difficult as a business matter to impose additional debt (in addition to any preexisting debt) up to 50 percent of the value of the entity in the transaction.

In the context of the "sales like" reorganization, pure preferred stock also could not satisfy the requirements of certain reorganization structures that require the use of "voting" stock.

Extraction of value prior to a spin off

Some might question the policy reason for restricting the ability of a distributing parent corporation to extract value from a controlled subsidiary prior to distributing that subsidiary. To the extent the parent corporation had basis in its stock of the subsidiary, for example, it might be questioned why parent should be limited in its ability to extract value up to 50 percent of the controlled subsidiary through sales of subsidiary stock. If the value extracted exceeds parent's basis in the subsidiary stock, it is argued, the parent would recognize taxable gain in any event. However, the parent may not in fact recognize gain. As one example, an excess loss account in a consolidated group, created by distributions in excess of parent's stock basis, might be eliminated through intercompany transactions (such as a liquidation or deemed liquidation), so that gain recognition does not occur when ownership of the subsidiary is divested such that the subsidiary leaves the consolidated group.[368] In any event, the proposal does not generally restrict such transactions, except to the extent that corporate ownership fails to satisfy the proposal's consolidated group control test. Proponents would contend that if ownership does not satisfy that level prior to the separation, the separation should not be treated as a tax-free restructuring of a single corporate entity in any event.

[367] To avoid gain recognition on receipt of such stock, the stock generally must avoid terms that would cause it to be "nonqualified preferred stock" within the meaning of section 351(g).

[368] See Andrew J. Dubroff, Jerred G. Blanchard, Jr., John Broadbent, and Kevin A. Duvall, *Federal Income Taxation of Corporations Filing Consolidated Returns (2d. ed.)*, LexisNexis 2013, par. 52.05[3].

L. Prevent Elimination of Earnings and Profits Through Distributions of Certain Stock

Present Law

Shareholder treatment of property distributions

Generally, a shareholder that receives a distribution of property from a corporation, made with respect to the shareholder's stock, must include in gross income the portion of the distribution that is a dividend.[369] The total amount of the distribution is the fair market value of the property distributed. Generally, a distribution is a dividend to the extent that it is out of current or accumulated corporate earnings and profits of the distributing corporation.[370] The amount of a distribution received by a shareholder that exceeds the relevant earnings and profits is not a dividend, but is applied against and reduces the shareholder's adjusted basis of the distributing corporation's stock, and is not taxed to the shareholder. Any amount distributed in excess of the shareholder's basis is treated as gain from the sale or exchange of the shareholder's stock.[371]

Earnings and Profits

Earnings and profits (often referred to as "E&P") can differ from the taxable income of a corporation. Earnings and profits is intended to measure the economic dividend-paying capacity of a corporate entity. Certain adjustments to taxable income are made to arrive at earnings and profits. As one example, certain accelerated depreciation deductions that reduce taxable income for the year are not allowed in computing earnings and profits until later years, on the theory that earnings and profits should more closely match the decline in economic value of corporate assets.[372] As another example, net capital losses that are recognized in the current year but not

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[369] Sec. 301(c)(1). Corporate shareholders may be eligible for a dividends received deduction ranging from 70 percent to 100 percent of the dividend, depending on the stock ownership of the corporate shareholder. Sec. 243.

[370] Sec. 316. As discussed further below, certain distributions in redemption of a shareholder's stock are treated as sales of the stock, rather than dividends, if the shareholder's interest in the corporation is sufficiently reduced after the redemption. Sec. 302. The corporation's earnings and profits in such case are reduced by the ratable share of earnings and profits attributable to the stock redeemed. Sec. 312(n)(7).

[371] Sec. 301(c). In addition to these rules, other rules treat certain payments as a dividend in corporate reorganization transactions that are otherwise tax-free. These rules are discussed in connection with the President's proposal entitled "Repeal Gain Limitation for Dividends Received in Reorganization Exchanges." In general, present law limits the amount that is treated as a dividend in such cases to the amount of gain that would be recognized had the stock been sold.

[372] Sec. 312(k).

deductible in the current year, and that must be carried forward, nevertheless generally do reduce earnings and profits for the year recognized.[373]

In a parent-subsidiary chain of controlled corporations, it is possible for a parent corporation to have earnings and profits while a subsidiary does not, or vice versa. An affiliated group of U.S. corporations that files a U.S. consolidated income tax return is subject to Treasury regulations that generally reduce this potential by requiring a "tiering up" of earnings and profits from lower-level subsidiaries to parent corporations.[374] However, even in the case of a consolidated income tax return, it may be possible in limited instances for the situation to occur.

A corporation in one chain of controlled corporations under a parent corporation likewise may have earnings and profits, while a "sister" corporation in a separate chain may not.

Certain Code provisions permit distributions from a lower tier subsidiary corporation to a parent corporation, or to a shareholder of the parent corporation, to bypass other upper-tier corporations in the chain, by creating fictional distributions treated as coming directly from the paying corporation to the recipient. For example, section 304 treats certain "deemed redemption" payments made to a parent corporation by a lower tier subsidiary corporation, in exchange for stock of the parent or of another subsidiary corporation, as made directly from the earnings and profits of the corporation that acquired the stock and then from the earnings and profits of the corporation that issued the stock.[375] As another example, section 956 treats lower tier foreign subsidiary acquisitions of U.S. property from a parent corporation as if the lower tier subsidiary paid a dividend directly to the U.S. parent.[376]

Significance for cross border distributions

A shareholder does not generally include in income earnings and profits of a corporation in which the shareholder owns stock until earnings are distributed. However, a U.S. corporate shareholder must include in its income certain undistributed "subpart F" income of a foreign corporation that is a "controlled foreign corporation," and of which the U.S. corporation is a 10

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[373] Treas. Reg. sec. 1.312-7(b)(1). A capital loss carryforward that is deductible in a year following the year of recognition of the net capital loss does not reduce earnings and profits in that later year because it was not recognized in that year. The regulations state: "A loss . . . may be recognized though not allowed as a deduction (by reason, for example, of the operation of sections 267 and 1211 and corresponding provisions of prior revenue laws." *Idem.*

[374] A foreign corporation cannot be a member of an affiliated group that files a consolidated U.S. tax return. Sec. 1504(b)(3).

[375] If the acquiring corporation is a foreign corporation, special rules apply under section 304(b)(5). The Treasury Department recently issued a notice regarding the rules under section 304(b)(5)(B) relating to situations in which foreign acquiring corporate earnings and profits would not be subject to tax nor included in earnings and profits of a controlled foreign corporation. Notice 2014-52 (September 22, 2014).

[376] Notice 2014-52, *supra*, announces limitations on this "hopscotch" effect under section 956 in the case of certain "inversion" transactions.

percent or greater shareholder.[377] Such income is only included to the extent that the controlled foreign corporation has earnings and profits.[378] Also, a special rule treats gain from the sale or exchange of foreign corporation stock, by a U.S. person who is a 10 percent shareholder, as instead a dividend from the earnings and profits of the entity whose stock was sold.[379]

A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a "deemed-paid" credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed as a dividend or is included in the domestic corporation's income under the anti-deferral rules.[380] However, if the included earnings and profits have borne relatively little foreign tax, little foreign tax credit offset may be available to reduce U.S. tax on the income inclusion.

If a foreign corporation's earnings and profits can be reduced or eliminated prior to that corporation making a distribution to a U.S. parent corporation, then the distributed funds can be repatriated without U.S. tax to the extent of the tax basis in the foreign corporation shares because the distribution is treated as a nontaxable return of capital, rather than as a dividend.[381]

Corporate gain or loss, and earnings and profits, on property distributions

On a distribution of property with a basis lower than fair market value, the distributing corporation recognizes gain,[382] reflected as a corresponding increase in earnings and profits. Earnings and profits are then decreased by the value of the property distributed.[383]

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[377] Sec. 951.

[378] Sec. 952(c). The rule limits the inclusion to current earnings and profits, reduced by certain past deficits in earnings and profits and modified for certain items. Other anti-deferral regimes, such as the passive foreign investment company rules (secs. 1291 et. seq.) the "accumulated earnings tax" rules (sec. 530 et. seq.), and the personal holding company rules (sec. 540 et. seq.), are similarly directed at undistributed earnings and profits.

[379] Sec. 1248. This characterization applies if a U.S. person sells or exchanges stock of a foreign corporation of which the U.S. shareholder owned or is deemed to have owned 10 percent or more of the voting power at any time during the 5-year period ending on the date of the sale, when such foreign corporation was a controlled foreign corporation.

[380] Secs. 901, 902, 960. A credit is also allowed for foreign taxes with respect to certain income included by a U.S. shareholder of a passive foreign investment corporation. Sec. 1291(g).

[381] In other situations, it may be advantageous for a U.S. parent corporation if a particular foreign subsidiary has earnings and profits. As one example, higher foreign tax rates and higher foreign taxes paid by the foreign subsidiary can result in excess foreign tax credits that can be used to shelter other taxable income if deemed paid from the earnings and profits of that subsidiary. See generally, Jasper L. Cummings, Jr., "Managing Foreign E&P" *Tax Notes*, July 21, 2014, pp. 337-347.

[382] Sec. 311.

[383] Sec. 312.

However, on a distribution of property with a basis higher than fair market value, the income tax and earnings and profits rules differ with respect to the potential loss. No loss is generally recognized on the distribution (except in certain liquidating distributions),[384] but earnings and profits are reduced by the basis of the property distributed.[385]

Corporate loss on property sales where basis exceeds value

If, instead of distributing to its shareholders property with a basis higher than fair market value, a corporation sells that property in a taxable sale to an unrelated party, the corporation recognizes the loss and the loss reduces the corporation's earnings and profits. If the corporation sells the loss property to a related party, the deduction for the loss is generally disallowed,[386] but the earnings and profits of the selling corporation are reduced by the amount of the loss, because the loss is recognized, even though the deduction was disallowed.[387]

If a corporation sells loss property within a controlled group of corporations,[388] however, the loss is not entirely disallowed. Instead, the loss is deferred until the property is transferred outside the controlled group and there would be recognition of loss under consolidated return principles or until such other time as may be prescribed in regulations.[389] Treasury regulations provide that this rule postpones recognition of the loss for purposes of reducing earnings and profits.[390]

Stock redemptions and "deemed redemptions" treated as dividends

An actual redemption of stock, though in form a sale by a shareholder of a corporation's stock to that corporation in exchange for property, is treated as a dividend if the redeemed shareholder's interest in the corporation is not sufficiently reduced following the redemption (and assuming there are sufficient earnings and profits to support dividend treatment).[391] Attribution rules[392] apply to determine the extent of the redeemed shareholder's ownership before and after the redemption. Also, under the so-called "deemed redemption" rules of section

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[384] Secs. 311, 336(d).

[385] Sec. 312.

[386] Sec. 267.

[387] Treas. Reg. sec. 1.312-7(b)(1). This regulation preceded the enactment of section 267(f).

[388] A controlled group is defined for this purpose by reference to a "more than 50 percent" relationship test, rather than "at least 80 percent." Sec. 267(f).

[389] Sec. 267(f).

[390] Treas. Reg. sec. 1.267(f)-1(g).

[391] Sec. 302.

[392] Sec. 318.

304, a sale of stock of one corporation to an acquiring corporation that is under common control with the selling corporation is treated as a dividend to the group member that sold the stock and received the payment for it, using a number of statutory fictional constructs. As one example, if a parent corporation controls two subsidiaries and one purchases the stock of the other from the parent for cash, the transaction is treated as a deemed contribution of the purchased stock to the purchasing corporation for new stock of the purchasing corporation, followed by a redemption of that new stock in a transaction that is tested for dividend equivalence.[393] When a subsidiary corporation acquires stock of its parent corporation, the transaction is treated as a redemption of the stock of the parent corporation.[394]

Stock basis after dividends, and after redemptions and deemed redemptions that are treated as dividends.

If a shareholder receives a dividend, the basis of the shareholder's stock is not generally reduced because no part of that basis has been used to offset and measure gain, as would occur in a sale of the stock.[395]

If an actual[396] or deemed[397] redemption of stock is treated as equivalent to the receipt of a dividend by a shareholder, a shareholder will typically increase its basis in any remaining stock of the corporation that the redeemed shareholder holds or is deemed to hold, by the amount of basis in the redeemed stock. The law is unclear regarding the specific treatment of the basis of redeemed stock when the shareholder does not own any remaining stock after the redemption, and may not even have actually owned any stock prior to the redemption. Such cases arise because dividend treatment can result from attribution rules under section 302, or from the special fictional transaction rules of section 304. However, taxpayers often take the position that a basis increase in some stock within the group is appropriate.[398]

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[393] Sec. 304(a)(1). In testing dividend equivalence under section 304, the earnings and profits of the acquiring corporation, and also of the corporation whose stock was transferred, are taken into account. Sec. 304(b)(2).

[394] Sec. 304(a)(2).

[395] In limited cases, however, special rules apply that require basis reduction for the amount of the corporate dividends-received deduction for certain "extraordinary dividends." These rules, contained in section 1059, are discussed further below. Also, if the distributing and recipient corporations are members of an affiliated group filing a consolidated return, Treasury regulations apply that usually require a stock basis reduction. A foreign corporation is not eligible to be a member of such a group filing a U.S. consolidated tax return. Sec. 1504(b)(3).

[396] Sec. 302.

[397] Sec. 304.

[398] Treasury has challenged this result in some cases. See, *e.g.*, Notice 2001-45, 2001-2 C.B. 129. Currently proposed regulations would deny an immediate upward basis adjustment in certain related party transactions, but treat the adjustment as a deferred loss. Prop. Reg. sec. 1.302-5, REG-14368607, 2009-1 C.B. 579. For more extensive discussion, see Boris I. Bittker and James S. Eustice, Federal Income Taxation of Corporations and Shareholders, (7th Ed., WG&L, 2013) paragraphs 9.09[3][e] and 9.22[2].

Treasury regulations relating to actual dividend-equivalent redemptions provide three examples of the treatment of the basis of redeemed stock.[399] All three examples involve individual shareholders.[400] In the first example, half of a shareholder's stock is redeemed in a transaction that constitutes a dividend. The example states that the basis of the redeemed stock is added to the basis of the shareholder's remaining stock. In the second example, husband and wife each own half of a corporation's stock. All of husband's stock is redeemed, but the transaction is treated as a dividend due to the treatment of husband and wife as a single shareholder under the attribution rules, whose interest has not been reduced. The example states that after the transaction, the basis of the husband's redeemed shares is added to the basis of the wife's shares. In the third example, most, but not all, of the husband's shares are redeemed. Again, the transaction is treated as a dividend due to attribution rules. In this case the example states that the basis of the redeemed shares is added to the basis of the husband's remaining non-redeemed shares.

Section 1059 downward basis adjustment for non-taxed portion of extraordinary dividends

Present law requires downward basis adjustments for the non-taxed portion of an "extraordinary dividend" when all or a portion of the dividend was not taxed to a corporate recipient because of the dividends received deduction.[401] That rule is intended to restrict the potential for artificial losses in cases where a corporate taxpayer purchases stock (thus obtaining a fair market value basis) prior to a dividend, receives the dividend and excludes all or a portion from taxable income due to the dividends received deduction, and then sells the stock (with otherwise unreduced basis) at a loss due to the diminution in value of the stock following payment of the dividend. The extraordinary dividend provisions contain special rules that apply more comprehensively than in other transactions in the case of non-pro-rata redemptions of stock under section 302, deemed redemptions under section 304, and certain redemptions that are treated as a dividend solely as a result of certain attribution rules relating to options.[402]

Description of Proposal

The proposal would amend the application of the general earnings and profits adjustment rules in the case of distributions of stock of another corporation.[403] As under present law, a

[399] Treas. Reg. sec. 1.302-2(c).

[400] Hence, no shareholder was eligible for the corporate shareholder dividends-received deduction, or for any foreign tax credit, with respect to the dividend. At the time the regulations were issued, there also was no special rate for most dividends paid to individuals, unlike present law which provides a lower rate for "qualified dividends" that is the same as the long-term capital gains rate.

[401] Sec. 1059. See also Treas. Reg. sec. 1.1059(e)-1.

[402] Sec. 1059(e). The rules also apply to transactions treated as a partial liquidation of a corporation under section 302(e). In the case of redemptions that are treated as dividends under section 304 or as a result of option attribution, only the basis of the stock redeemed is taken into account under section 1059. (sec. 1059(e)(1)).

[403] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budgetary Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item VIII.L, reprinted in the back of this volume.

corporation's distribution of stock of another corporation would reduce the distributing corporation's earnings and profits in any taxable year by the greater of the stock's fair market value or the distributing corporation's basis in the stock. However, where the distributing corporation's basis in the distributed stock is greater than the fair market value of such stock, the distributing corporation's basis in the distributed stock for purposes of computing the reduction in earnings and profits of the distributing corporation would be determined without regard to any adjustments as a result of actual or deemed dividend equivalent redemptions by the corporation whose stock is distributed and without regard to any series of distributions or transactions undertaken with a view to create and distribute high-basis stock of any corporation. The Treasury Department would be granted regulatory authority necessary or appropriate to carry out the proposal.

Effective date.−The proposal would be effective upon enactment.

Analysis

The proposal limits the extent to which a distribution of stock that has a basis higher than fair market value can reduce earnings and profits of the distributing corporation. The proposal requires the stock's basis for this purpose to be computed by ignoring any adjustments to basis that resulted from actual (section 302) or deemed (section 304) dividend equivalent redemptions by the corporation whose stock is distributed, or from any series of distributions or transactions undertaken with a view to create and distribute high-basis stock of any corporation.

Since taxpayers often have the option to structure a transaction either as a direct dividend or as a redemption or deemed redemption, corporate taxpayers might choose the latter structures for tax purposes. Cases of particular concern may involve situations in which the amount treated as a dividend in the redemption or deemed redemption was not subject to U.S. tax when received, yet the basis of stock is increased by the basis of stock redeemed, or deemed to be redeemed. For example, if a controlled foreign corporation is treated as receiving a dividend from another controlled foreign corporation, the "same country" exception[404] or the "look through" exception[405] of present law may permit that receipt without the imposition of U.S. tax under subpart F of the Code.

Example: US corporation (US) owns all of CFC1 (with a high basis but no earnings and profits), which in turn owns all 100 shares of CFC2. Each share of CFC2 stock has a basis of $1 in the hands of CFC1 and is worth $1. CFC2 redeems 99 shares of its stock from CFC1 for $99 in cash. CFC2 has sufficient earnings and profits, and this transaction is treated as a dividend to CFC1 (but without any current U.S. tax imposed on that dividend, assuming application of the "same country" and/or "CFC look-through" exception). CFC1 now has $99 earnings and profits, $99 cash, and one share of CFC2 stock, with a basis of $100 and a value of $1. CFC1 might now eliminate its $99 of earnings and profits by distributing the one high basis share of CFC2 stock to US. Since the value of the stock distributed is only $1, US includes only $1 as the amount of

[404] Sec. 954(c)(3)(A)(i).

[405] Sec. 954(c)(6).

dividend received. The distribution eliminates CFC1's earnings and profits since it reduces such earnings and profits (but not below zero) by $100, the basis of the stock distributed. In the following year, CFC1 distributes the $99 cash that it received from CFC 2 to US. Since CFC1 has no earnings and profits for the year of that distribution, that distribution is not taxable to US. Rather, the distribution reduces US's basis in its stock of CFC1.

The proposal would prevent the elimination of earnings and profits through distributions of stock with a basis higher than value but only to the extent of any upward adjustments to the basis of that stock that occurred in connection with a dividend-equivalent redemption or deemed redemption, and other cases involving a series of distributions or transactions undertaken with a view to create and distribute high-basis stock of any corporation. The proposal would clearly affect section 302 and 304 transactions. Other cases would involve a facts and circumstances inquiry that might be difficult to apply effectively. Where the proposal applies, it would prevent the elimination of earnings and profits when stock with applicable basis adjustments is distributed to a shareholder and hence, the stock is not necessarily disposed of outside a corporate group.

The proposal does not require a reduction in the basis of stock for the relevant basis amounts in cases where the stock is sold. As one example, stock might be sold among related parties, so that a loss on the stock sale would be either disallowed or deferred under section 267. In such cases, the basis of the stock for purposes of determining the reduction in earnings and profits would remain high, and would reduce earnings and profits when the loss is recognized, whether immediately, under section 267(a) (if the sale is to a related party that is not within a controlled group), or on a deferred basis under section 267(f) (if the sale is within a controlled group of corporations that is followed by a disposition outside the controlled group). High-basis, low-value stock might also be sold immediately, outside the corporate group and to an entirely unrelated party, in a case to which section 267 would not apply. Such sales reduce the earnings and profits when the loss is recognized. The proposal could be more comprehensive if it applied to those situations as well as to distributions.

Consideration might be given to revisiting and clarifying the rules relating to the adjustment of the basis of remaining stock in cases of dividend equivalent or deemed dividend redemptions generally.

The proposal also does not address other ways in which earnings and profits might be moved among corporations in a controlled group.[406]

[406] See generally, Jasper L. Cummings, Jr., "Managing Foreign E&P," *Tax Notes* July 21, 2014, pp. 337-347.

PART IX − INCENTIVES FOR JOB CREATION, CLEAN ENERGY, AND MANUFACTURING

A. Provide Additional Tax Credits for Investment in Qualified Property Used in a Qualifying Advanced Energy Manufacturing Project

Description of Modification

The fiscal year 2014 budget proposal is modified by specifying that up to $200 million of authorized credits may be allocated to the construction of infrastructure that contributes to networks of refueling stations that serve alternative fuel vehicles.[407]

B. Designate Promise Zones

Description of Modification

The fiscal year 2014 budget proposal is modified by providing that, (i) all zone designations begin in 2015, and are not staggered over four years, (ii) the 20 promise zones include zones that competed in 2013 for promise zone designations awarded in 2014, and (iii) the Secretary of Agriculture and the Secretary of Housing and Urban Development (as opposed to the Secretary of Commerce which was referenced in the prior proposal) has the authority to select the zones, and they may require the nominating local government to provide data on the economic conditions in the zones before and after designation to evaluate the effectiveness of the program.[408]

C. Provide New Manufacturing Communities Tax Credit

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 83-87. The estimated budget effect of the current proposal

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[407] The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 15-18, and is modified by the fiscal year 2014 budget proposal, described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 59. The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal (JCX-36-14), Item IX.A., reprinted in the back of this volume.

[408] This proposal is substantially similar to a proposal found in the fiscal year 2014 budget proposal. The 2014 budget proposal was a modification of the fiscal year 2013 budget proposal. That modification is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 60. The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, p. 152. The estimated budgetary effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), Item IX.B, reprinted in the back of this volume.

can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item IX.C, reprinted in the back of this volume.

D. Credit for Advanced Technology Vehicles

Description of Modification

The fiscal year 2014 budget proposal is modified by changing the tax incentive from a seller credit to a manufacturer credit.[409] Under the 2014 proposal, the credit is allowed to the person that sold the vehicle to the person placing the vehicle in service (or, at the election of the seller, the person financing the sale), but only if the amount of the credit is disclosed to the purchaser. Under the fiscal year 2015 proposal, the credit is available to the manufacturer of the vehicle, but the manufacturer has the option to transfer the credit to a dealer that sells the vehicle or to the end-use purchaser of the vehicle. In addition, under the 2015 proposal, if the credit is transferred to an end-use business purchaser, the purchaser is not required to reduce the basis of depreciable property by the amount of the credit.

E. Credit for Medium and Heavy Duty Alternative Fuel Vehicles

Description of Modification

The fiscal year 2014 budget proposal is modified in several ways. First, the incentive is changed from a buyer credit to a manufacturer credit.[410] Under the 2014 proposal, the credit is allowed to the person placing the vehicle in service or, in the case of a vehicle placed in service by a tax-exempt or governmental entity, to the person that sold the vehicle to such entity (or, at the election of the seller, to the person financing the sale), but only if the amount of the credit is disclosed to purchaser. Under the fiscal year 2015 proposal, the credit is available to the manufacturer of the vehicle, but the manufacturer has the option to transfer the credit to a dealer that sells the vehicle or to the end-use purchaser of the vehicle. Second, under the 2015 proposal, if the credit is transferred to an end-use business purchaser, the purchaser is not required to reduce the basis of depreciable property by the amount of the credit. Third, the amount of the credit is increased from 50 percent of the incremental cost of the alternative fuel vehicle, up to $25,000 or $40,000 per vehicle depending on the vehicle's weight, to a flat credit

[409] The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 117-123. The fiscal year 2014 budget proposal is identical to the fiscal year 2013 budget proposal. The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal (JCX-36-14), Item IX.D., reprinted in the back of this volume.

[410] The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 117-123. The fiscal year 2014 budget proposal is identical to the fiscal year 2013 budget proposal. The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal (JCX-36-14), Item IX.E., reprinted in the back of this volume.

of $25,000 for dedicated alternative fuel vehicles weighing between 14,000 and 26,000 pounds, and $40,000 for heavier vehicles.

F. Modify Tax-Exempt Bonds for Indian Tribal Governments

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 180-183. The estimated budget effect of that proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item IX.F, reprinted in the back of this volume.

G. Extend the Tax Credit for Cellulosic Biofuels

Present Law†

In 2013, the "cellulosic biofuel producer credit" was renamed the "second generation biofuel producer credit." The second generation biofuel producer credit provides a tax incentive for both cellulosic biofuels and algae. The credit is a nonrefundable income tax credit for each gallon of qualified second generation biofuel production of the producer for the taxable year. The amount of the credit is generally $1.01 per gallon. The second generation biofuel producer credit terminated on December 31, 2013.

"Second generation biofuel production" is any second generation biofuel that is produced by the taxpayer and which during the taxable year is: (1) sold by the taxpayer to another person (a) for use by such other person in the production of a qualified second generation biofuel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or (c) who sells such second generation biofuel at retail to another person and places such second generation biofuel in the fuel tank of such other person; or (2) used by the producer for any purpose described in (1)(a), (b), or (c).

"Second generation biofuel" means any liquid fuel that (1) is derived from qualified feedstocks, (2) produced in the United States and used as fuel in the United States, and (3) meets the registration requirements for fuels and fuel additives established by the Environmental Protection Agency ("EPA") under section 211 of the Clean Air Act. Qualified feedstocks means any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis and any cultivated algae, cyanobacteria, or lemna. The second generation biofuel producer credit cannot be claimed unless the taxpayer is registered by the IRS as a producer of second generation biofuel.

Second generation biofuel does not include certain unprocessed fuel. Unprocessed fuels are fuels that (1) are more than four percent (determined by weight) water and sediment in any combination, or (2) have an ash content of more than one percent (determined by weight). Second generation biofuel eligible for the second generation biofuel credit is precluded from

qualifying as biodiesel, renewable diesel, or alternative fuel for purposes of the applicable income tax credit, excise tax credit, or payment provisions relating to those fuels.

The second generation biofuel producer credit is part of the general business credits in section 38. However, unlike other general business credits, the second generation biofuel producer credit can only be carried forward three taxable years after the termination of the credit. The credit is also allowable against the alternative minimum tax. Under section 87, the credit is included in gross income.

Description of Proposal

The proposal would retroactively extend the tax credit for blending cellulosic fuel at $1.01 per gallon through December 31, 2020, and would then reduce the amount of the credit by 20.2 cents per gallon in each subsequent year, so that the credit would expire after December 31, 2024.[411]

Analysis

The proposal to renew and extend the cellulosic biofuel credit could be evaluated on how such a proposal would (1) provide certainty and stability, (2) contribute to U.S. energy independence, and (3) be technology neutral.

Certainty and stability

The cellulosic biofuel credit was added to the Code by the 2008 Farm bill at $1.01 per gallon and was scheduled to expire at the end of calendar year 2012.[412] In January, 2013, after the credit had expired, the credit was retroactively extended through the end of calendar year 2013.[413] In general, renewable energy tax credit have been subject to multiple short-term extensions and retroactive renewals. This uncertainty makes such projects unattractive to investors and can create "boom-and-bust" cycles.[414] Under the proposal, the credit would be retroactively extended but would be available for another 10 years, through the end of 2024. Some would argue that having the credit available for 10 years would provide certainty to investors and to taxpayers in terms of factoring in the credit as part of the facilities financial viability. Some might argue that the credit hinders such projects from becoming commercially viable without government assistance and encourages dependence on such aid. Proponents

[411] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14) April 15, 2014, Item IX.G, reprinted in the back of this volume.

[412] Pub. L. No. 110-246, sec. 15321.

[413] Pub. L. No. 112-240, sec. 404.

[414] Dan W. Reicher, Statement of Dan W. Reicher, Executive Director, Steyer-Taylor Center for Energy Policy & Finance at Stanford University to the Senate Finance Committee, Subcommittee on Energy, Natural Resources, and Infrastructure, Hearing on Principles for Energy Tax Reform (July 31, 2013) p. 3 (http://www.finance.senate.gov/imo/media/doc/Reicher%20Testimony.pdf).

would counter that, under the budget proposal, the credit begins to be reduced in 2020 by 20.2 cents each year, in attempt to wean projects from the credit. Others would argue that both the 10-year period and the amount of the reduction is arbitrary and that the evaluation of the progress made by the industry and the need for the credit should be evaluated over a shorter-time frame with clear benchmarks and goals to determine the efficacy of the credit.

Energy independence through development of domestic resources

Over many years, high prices for gasoline and the need to import oil from foreign sources into the United States have prompted a longstanding concern about energy security within the United States. Some argue that geopolitical disturbances which could cause crude oil price volatility make imperative the development of domestic resources to displace petroleum. It is believed that cellulosic feedstocks, such as corn stover and switchgrass could potentially be a significant source of biofuel.

Some would argue that a production tax credit is inappropriate at this stage of cellulosic biofuel development and feasibility. Conventional ethanol is made from the fermentation of corn starches and sugars into alcohol and is widely produced on a commercial scale. On the other hand, cellulose must first be broken down into sugars and starches through enzymatic or thermochemical processes before fermentation, or converted into a synthesis gas before being used to produce fuel.[415] While the potential supply of cellulosic feedstock is abundant, the processes for converting such feedstock into fuel is prohibitively expensive when compared to other conventional and alternative fuel options.[416] Thus, some would argue that Federal government dollars would be better invested in research and development to bring down the cost of the techniques that could be used to convert cellulosic materials into fuel. In addition, it may be unlikely that a business in its infancy would generate sufficient tax liability to utilize the credit and that the pool of investors with sufficient liability to enter this market is limited. In addition, as the cellulosic biofuel technology is not yet proven and widely used on a commercial scale, investors may be reluctant to fund projects viewed as having too much risk.

Some argue that a production tax credit is not the proper incentive if the industry cannot secure the financing and technology to get the facility built and producing fuel on a commercial scale. As noted above, converting cellulosic material into fuel is expensive. The Federal government may see more national benefit to providing grants and financing vehicles for the development and construction of the facilities than subsidizing the production of a few companies producing fuel in very minor quantities when compared with overall transportation fuel needs.

Some perceive cellulosic biofuel as a pathway to creating "green jobs" by attracting investment and spurring economic development. However, some would argue that such economic effect on a broad scale is speculative until the technology can produce fuel on a commercial scale.

Renewable Fuel Standard interaction

The Renewable Fuel Standard (RFS) requires increasing amounts of biofuels be used in transportation fuel (36 billion gallons in 2022). Yet, the Environmental Protection Agency

[415] Congressional Research Service, R40168, Alternative Fuels and Advanced Technology Vehicles: Issues in Congress (April 4, 2013) p. 9.

[416] *Ibid*.

(EPA) concluded that there was insufficient domestic production capacity to meet the RFS mandate for cellulosic biofuel for several years (2010, 2011, 2012, 2013 and 2014). For each of those years, the EPA reduced the mandate volumes significantly. The cellulosic biofuel production tax credit has been in place for fuel produced after December 31, 2008. Even with a reduced mandate and a production subsidy of $1.01 per gallon, the 2010-2012 mandates were not met by actual production of cellulosic biofuel, but met largely with RFS waivers. Thus, some could argue that the production tax credit was not particularly effective in spurring large scale production during its five years of existence.

Technology neutrality

Some argue that the tax code should not pick "winners and losers" but should be "technology neutral" in providing incentives. On the one hand, the cellulosic biofuel credit could be considered technology neutral in that the credit does not specify the process by which the biofuel is made. As noted above, the making of cellulosic biofuel could be made through enzymatic means, pyrolysis, and other methods to break down the cellulose. In comparison, the alternative fuel credit for fuel made from coal is only available if made through the Fischer-Tropsch process.

Some would argue that the cellulosic biofuel credit is not "technology neutral" because it encourages only development of fuel from cellulosic sources when fuel from sources other than cellulosic might prove just as viable. Some would argue that the Code's diverse incentives for various fuel types (cellulosic biofuel (at 1.01 per gallon), biodiesel (at $1.00 per gallon), renewable diesel (at $1.00 per gallon), and alternative fuel (at 50 cents per gallon)) is not part of a cohesive energy security policy and that all specialized incentives should be removed in favor of general business investment incentives, such as accelerated depreciation.

H. Modify and Permanently Extend the Credit for Energy Efficient New Homes

Present Law†

Present law provides a credit to an eligible contractor for each qualified new energy-efficient home that is constructed by the eligible contractor and acquired by a person from such eligible contractor for use as a residence during the taxable year. To qualify as a new energy-efficient home, the home must be: (1) a dwelling located in the United States, (2) substantially completed after August 8, 2005, and (3) certified in accordance with guidance prescribed by the Secretary to have a projected level of annual heating and cooling energy consumption that meets the standards for either a 30-percent or 50-percent reduction in energy usage, compared to a comparable dwelling constructed in accordance with the standards of chapter 4 of the 2006 International Energy Conservation Code as in effect (including supplements) on January 1, 2006, and any applicable Federal minimum efficiency standards for equipment. With respect to homes that meet the 30-percent standard, one-third of such 30-percent savings must come from the building envelope, and with respect to homes that meet the 50-percent standard, one-fifth of such 50-percent savings must come from the building envelope.

Manufactured homes that conform to Federal manufactured home construction and safety standards are eligible for the credit provided all the criteria for the credit are met. The eligible contractor is the person who constructed the home, or in the case of a manufactured home, the producer of such home.

The credit equals $1,000 in the case of a new home that meets the 30-percent standard and $2,000 in the case of a new home that meets the 50-percent standard. Only manufactured homes are eligible for the $1,000 credit.

In lieu of meeting the standards of chapter 4 of the 2006 International Energy Conservation Code, manufactured homes certified by a method prescribed by the Administrator of the Environmental Protection Agency under the Energy Star Labeled Homes program are eligible for the $1,000 credit provided criteria (1) and (2), above, are met.

The credit applies to homes that are purchased prior to January 1, 2014. The credit is part of the general business credit.

Description of Proposal

The proposal extends the current tax credit to homes that are acquired prior to January 1, 2015. For homes acquired after December 31, 2014 and prior to January 1, 2025, the credit structure and qualifying standards are modified. Under the proposal, a $1,000 credit is available for Energy Star certified new homes acquired for use as a residence. A $4,000 credit is available for homes that meet the standards of the Department of Energy Challenge Homes program[417].

Effective date.−The proposal is effective for homes acquired after December 31, 2013.

Analysis

Economists are generally skeptical of government interventions in markets that alter prices from those that would otherwise prevail in a free market, but most economists agree that an economic rationale for government intervention in certain markets (including many aspects of energy markets) exists when there are "externalities" in the consumption or production of certain goods that lead to "market failures," wherein either too little or too much of certain economic activity occurs relative to what is the socially optimal level of activity. Pollution is an example of a negative externality, because the costs of pollution are borne by society as a whole rather than solely by the polluters themselves. In the case of pollution, there are various ways the government could intervene in markets to limit pollution to more economically efficient levels. One approach is to control pollution directly through regulation of polluters, such as by requiring coal burning electric utilities to install scrubbers to limit their emissions of various pollutants. Other more market oriented approaches to achieving socially optimal levels of pollution control are also possible, such as by setting a tax on the polluting activity that is equal to the social cost

[417] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item IX.H, reprinted in the back of this volume.

of the pollution. In the case of a positive externality, the appropriate economic policy is to impose a negative tax (*i.e.*, a subsidy) on the consumption or production that produces the positive externality, such that the socially optimal level of consumption or production results. An example where such a positive externality is thought to exist is in basic scientific research, as the social payoffs to such research are not fully captured by private parties that undertake, and incur the cost of, such research. As a result, a socially sub-optimal level of such research is undertaken. The provision of a subsidy for such research can correct this market inefficiency and lead to socially optimal levels of research.

Economists do not generally argue that the rationale for subsidizing energy efficient housing is that the production or consumption of energy efficient housing generates positive externalities. Rather, the argument made is that subsidizing the energy efficient housing will reduce consumption of fossil fuels that produce pollution and other negative externalities. However, economists generally agree that the most efficient means of addressing pollution would be a direct tax on the creation of the pollution, rather than an indirect approach such as targeted tax subsidies for certain energy-efficient technologies or mandated efficiency standards.[418] For example, one study of the proposed climate change legislation H.R. 2454, American Clean Energy and Security Act of 2009 (colloquially known as Waxman-Markey) found that the cap-and-trade provisions or the equivalent carbon tax abated carbon dioxide emissions at a cost of $12 per ton, while the energy efficiency standards of that legislation (including, for example, standards for building, lighting, and appliances) abated carbon dioxide emissions at five times the cost, or $60 per ton.[419]

The proposal is likely better targeted than prior law, as the Energy Star and Challenge Home standards address more aspects of the energy consumption of a typical home, such as that from appliances and lighting, whereas the prior law standard is focused only on heating and cooling demands. By providing the credit through 2024, the proposal provides greater planning certainty than would a short term extension of the credit, with or without modifications.

[418] For a discussion of these issues, see Hunt Allcott & Michael Greenstone, 2012. "Is There an Energy Efficiency Gap?," *Journal of Economic Perspectives*, American Economic Association, vol. 26(1), pp. 3-28, Winter. See also Testimony of Gilbert Metcalf, Professor of Economics, Tufts University, Senate Committee on Finance Hearing on "Neutrality in Energy Tax: Issues and Options," April 23, 2009, available at http://www.finance.senate.gov/imo/media/doc/042309gmtest.pdf

[419] Krupnick, Alan, Ian Parry, Margaret Walls, Tony Knowles, and Kristin Hayes. "Toward a New National Energy Policy: Assessing the Options." Resources for the Future, November 2010, available at http://www.ourenergypolicy.org/wp-content/uploads/2013/06/RFF-NEPI-Full-Report-Final-Nov-2010.pdf

I. Reduce Excise Taxes on Liquefied Natural Gas (LNG) to Bring Into Parity with Diesel

Present Law†

The Code imposes an excise tax on gasoline, diesel fuel, kerosene, and certain alternative fuels at the following rates:[420]

Gasoline	18.3 cents per gallon
Diesel fuel and kerosene	24.3 cents per gallon[421]
Alternative fuels	24.3 and 18.3 cents per gallon[422]

The Code imposes tax on gasoline, diesel fuel, and kerosene ("taxable fuels") upon removal from a refinery or on importation, unless the fuel is transferred in bulk by registered pipeline or barge to a registered terminal facility.[423] The imposition of tax on alternative fuels generally occurs at retail when the fuel is sold to an owner, lessee or other operator of a motor vehicle or motorboat for use as a fuel in such motor vehicle or motorboat.

One such alternative fuel is liquefied natural gas. Liquefied natural gas ("LNG") is taxed at the same per gallon rate as diesel, 24.3 cents per gallon.

Description of Proposal

The proposal would lower the 24.3 cents per gallon excise tax on LNG to 14.1 cents per gallon beginning after December 31, 2014.[424]

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[420] These fuels are subject to an additional 0.1-cent-per-gallon excise tax to fund the Leaking Underground Storage Tank ("LUST") Trust Fund (secs. 4041(d) and 4081(a)(2)(B)). That tax is imposed as an "add-on" to other existing taxes.

[421] Diesel-water emulsions are taxed at 19.7 cents per gallon (sec. 4081(a)(2)(D)).

[422] The rate of tax is 24.3 cents per gallon in the case of liquefied natural gas, any liquid fuel (other than ethanol or methanol) derived from coal, and liquid hydrocarbons derived from biomass. Other alternative fuels sold or used as motor fuel are generally taxed at 18.3 cents per gallon. "Alternative fuel" also includes compressed natural gas. The rate for compressed natural gas is 18.3 cents per energy equivalent of a gallon of gasoline. See sec. 4041(a)(2) and (3).

[423] Sec. 4081(a)(1).

[424] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item IX.I, reprinted in the back of this volume.

Analysis

According to the Department of Energy Alternative Fuels Data Center, diesel fuel has an energy content of 128,450 Btu per gallon (lower heating value). LNG has an energy content of 74,720 Btu per gallon (lower heating value) therefore a gallon of LNG produces approximately 58 percent of the energy produced by a gallon of diesel fuel.

Prior to the enactment of the Safe, Accountable, Flexible, Transportation Equity Act: A Legacy for Users (SAFETEA-LU) in 2005, LNG was taxed at 11.9 cents per gallon, however, there was no excise tax credit available to be used against this liability. After the enactment of SAFETEA-LU, fuels deemed to be substitutes for diesel fuel were taxed at the diesel fuel rate of 24.3 cents per gallon, however SAFETEA-LU also created a refundable excise tax credit of 50 cents per gallon for alternative fuels (including LNG), so that the net subsidy for LNG was 25.7 cents per gallon and to the extent such amount exceeded excise tax liability, that amount was refundable. The excise tax credit for alternative fuels expired December 31, 2013. However, the excise tax of 24.3 cents per gallon remains in place.

The full amount of the excise tax on LNG, 24.3 cents per gallon is dedicated to the Highway Trust Fund (taxes imposed and transferred to the fund were not reduced to take into account the alternative fuel excise tax credit.) Thus a reduction in the tax rate for LNG from 24.3 cents per gallon to 14.1 cents per gallon results in a decrease in receipts to the Highway Trust Fund at a time when the fund's projected expenditures are expected to significantly exceed its revenues. The Congressional Budget Office projections show a shortfall of $2 billion beginning in fiscal year 2015 and by fiscal year 2024, the cumulative shortfall is $157 billion.[425] Thus, some may argue that any reduction in Highway Trust Fund receipts at this time is ill-advised.

On the other hand, as a substitute for diesel fuel, some may argue that since the energy content of LNG is 58% of the energy content of diesel, the tax imposed on LNG should be 58% of the tax on diesel, or 14.1 cents per gallon because it takes more gallons of LNG to achieve the energy content of a gallon of diesel. They argue that using a per gallon/volume basis for taxation, instead of an energy equivalent, results in LNG being taxed at 170% of its diesel-gallon equivalent.[426]

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[425] Congressional Budget Office, *Projections of Highway Trust Fund Accounts Under CBO's August 2014 Baseline* (August 27, 2014) (http://www.cbo.gov/sites/default/files/cbofiles/attachments/43884-2014-08-HighwayTrustFund.pdf).

[426] See, NGVAmerica, *Statement of NVGAmerica, United States House of Representatives Tax Reform Working Groups: Manufacturing* (April 15, 2013), p. 6 (http://waysandmeans.house.gov/uploadedfiles/ngvamerica.pdf).

PART X − INCENTIVES FOR INVESTMENT IN INFRASTRUCTURE

A. Create the America Fast Forward Bond Program

Present Law

Under prior law, State and local governments were permitted to issue direct-pay Build America bonds (BABs). Enacted in 2009, the authority to issue BABs expired after December 31, 2010. A Build America Bond is any State or local governmental obligation (other than a private activity bond) if the interest on such obligation would be excludable otherwise from gross income under section 103 (relating to the tax-exemption for State and local government obligations). The interest paid with respect to a BAB is included in the holder's gross income. A BAB could not be a private activity bond. A BAB could be issued two different ways, as a tax-credit bond, allowing the holder to accrue a tax credit in the amount of 35 percent of the interest paid on the interest payment dates of the bond during the calendar year, or a direct-pay bond with the bondholder receiving interest included in gross income and the issuer receiving a Federal subsidy in the form of a payment equal to 35 percent of the interest payable on the bond. Most, if not all, issuers of BABs elected to issue direct-pay BABs with the subsidy paid by the Federal government to the issuer. In addition to disqualifying all private activity bonds from being BABs, direct-pay BABs could only be used for capital expenditures.

The Balanced Budget Act of 1985, as amended, required certain automatic reductions, which included BAB subsidy payments to issuers. For claims filed with the IRS after September 30, 2013, a sequestration reduction rate of 7.2 percent is applied to those payments (down from 8.7 percent for March 1, 2013, through September 30, 2013).

Description of Proposal

With respect to the proposal to create the America Fast Forward Bond Program, the proposal modifies the fiscal year 2014 proposal by precluding direct payments to State and local government issuers under the permanent America Fast Forward Bond program from being subject to sequestration.[427] For purposes of the proposal, the term "sequestration" means any reduction in direct spending pursuant to the Balanced Budget and Emergency Deficit Control Act of 1985, as amended, the Statutory-Pay-As-You-Go Act of 2010, as amended or the Budget Control Act of 2011, as amended.

Analysis

As noted above, BAB subsidy payments are subject to sequestration. Some argue that the post-issuance reduction in subsidy payments required by sequestration disrupted the financial plans and projections issuers made based on a 35 percent subsidy. As a result, a few issuers have

[427] The fiscal year 2014 budget proposal is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 61-68. The estimated budgetary effect of the fiscal year 2015 proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item X.A, reprinted in the back of this volume.

recalled their BABs, citing the reduction in Federal payments as an extraordinary circumstance warranting retirement of the bonds. Some argue that the uncertainty surrounding the current and possible future reductions could make the America Fast Forward Bond program less attractive to issuers and investors alike, resulting in fewer projects financed through the program. To avoid uncertainty regarding reductions of subsidy payments for the America Fast Forward Bond program, some argue that for the program to be successfully launched, the Federal subsidy payments should be exempt from the effects of sequestration.

The 28 percent subsidy is intended to approximate the subsidy level of a tax-exempt bond. Some argue that the 28 percent subsidy is still a deeper subsidy than that afforded by tax-exempt bonds. Under that assumption, the effect of a reduced payment under sequestration may be somewhat ameliorated because the issuer still receives a greater benefit by utilizing the America Fast Forward Bond program than by issuing traditional tax-exempt bonds. In addition, as demonstrated by the BAB program, the class of potential investors in an America Fast Forward Bond program is much broader than for traditional tax-exempt bonds, as it would reach those investors without regard to tax liability or interest in tax-exempt income (*e.g.*, pension funds).

B. Allow Current Refundings of State and Local Governmental Bonds

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 184-185. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item X.B, reprinted in the back of this volume.

C. Repeal the $150 Million Non-Hospital Bond Limitation on Qualified Section 501(c)(3) Bonds

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 69-70. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item X.C, reprinted in the back of this volume.

D. Increase National Limitation Amount for Qualified Highway or Surface Freight Transfer Facility Bonds

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 71-75. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the*

Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal (JCX-36-14), April 15, 2014, Item X.D, reprinted in the back of this volume.

E. Eliminate the Volume Cap for Private Activity Bonds for Water Infrastructure

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 76-78. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item X.E, reprinted in the back of this volume.

F. Increase the 25-Percent Limit on Land Acquisition Restriction on Private Activity Bonds

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 79-81. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item X.F, reprinted in the back of this volume.

G. Allow More Flexible Research Arrangements for Purposes of Private Business Use Limits

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 82-86. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item X.G, reprinted in the back of this volume.

H. Repeal the Government Ownership Requirement for Certain Types of Exempt Facility Bonds

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 87-88. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item X.H, reprinted in the back of this volume.

I. Exempt Foreign Pension Funds from the Application of the Foreign Investment in Real Property Tax Act (FIRPTA)

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 89-97. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item X.I, reprinted in the back of this volume.

PART XI − TAX CUTS FOR FAMILIES AND INDIVIDUALS

A. Expand the Earned Income Tax Credit for Workers Without Qualifying Children

Present Law

In general

Low- and moderate-income workers may be eligible for the refundable earned income credit ("EIC"). Eligibility for the EIC is based on earned income, adjusted gross income ("AGI"), investment income, filing status, number of children, and immigration and work status in the United States. The amount of the EIC is based on the presence and number of qualifying children in the worker's family, as well as on adjusted gross income and earned income.

The EIC generally equals a specified percentage of earned income up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the beginning of the phaseout range, the maximum EIC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

An individual is not eligible for the EIC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds $3,350 (for 2014). This threshold is indexed for inflation. Disqualified income is the sum of: (1) interest (both taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income that is not self-employment income (if greater than zero).

The EIC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer's Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment.

Filing status

An unmarried individual may claim the EIC if he or she files as a single filer or as a head of household. Married individuals generally may not claim the EIC unless they file jointly. An exception to the joint return filing requirement applies to certain spouses who are separated. Under this exception, a married taxpayer who is separated from his or her spouse for the last six months of the taxable year is not considered to be married (and, accordingly, may file a return as head of household and claim the EIC), provided that the taxpayer maintains a household that constitutes the principal place of abode for a dependent child (including a son, stepson, daughter, stepdaughter, adopted child, or a foster child) for over half the taxable year, and pays over half the cost of maintaining the household in which he or she resides with the child during the year.

Presence of qualifying children and amount of the earned income credit

Four separate credit schedules apply: one schedule for taxpayers with no qualifying children, one schedule for taxpayers with one qualifying child, one schedule for taxpayers with two qualifying children, and one schedule for taxpayers with three or more qualifying children. The values below are for 2014.[428]

Taxpayers with no qualifying children may claim a credit if they are over age 24 and below age 65. The credit is 7.65 percent of earnings up to $6,480, resulting in a maximum credit of $496. The maximum is available for those with incomes between $6,480 and $8,110 ($13,540 if married filing jointly). At that point, the credit begins to phase out at a rate of 7.65 percent of earnings above that threshold, resulting in a $0 credit at $14,590 of earnings ($20,020 if married filing jointly).

Taxpayers with one qualifying child may claim a credit of 34 percent of their earnings up to $9,720, resulting in a maximum credit of $3,305. The maximum credit is available for those with earnings between $9,720 and $17,830 ($23,260 if married filing jointly). At that point, the credit begins to phase out at a rate of 15.98 percent of earnings above this threshold, phasing out completely at $38,511 of earnings ($43,941 if married filing jointly).

Taxpayers with two qualifying children may claim a credit of 40 percent of earnings up to $13,650, resulting in a maximum credit of $5,460. The maximum credit is available for those with earnings between $13,650 and $17,830 ($23,260 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above that threshold, and is completely phased out at $43,756 of earnings ($49,186 if married filing jointly).

A temporary provision recently extended by the American Taxpayer Relief Act of 2012 ("ATRA")[429] allows taxpayers with three or more qualifying children to claim the EIC at an increased rate of 45 percent for taxable years before 2018. Thus, in 2014 taxpayers with three or more qualifying children may claim a credit of 45 percent of earnings up to $13,650, resulting in a maximum credit of $6,143. The maximum credit is available for those with earnings between $13,650 and $17,830 ($23,260 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above that threshold, and is completely phased out at $46,997 of earnings ($52,427 if married filing jointly).

A temporary provision recently extended by the ATRA increases the phase-out thresholds for married couples by $5,000 (indexed for inflation from 2009)[430] above the thresholds for other filers. In absence of this provision, the thresholds for married couples would be $3,000 above that for other filers (indexed for inflation from 2008). The increase is $5,430 for 2014. This increase expires for taxable years beginning after December 31, 2017.

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[428] All income thresholds are indexed for inflation annually.

[429] Pub. L. No. 112-240.

[430] A technical correction may be necessary to reflect that the $5,000 amount is indexed.

Description of Proposal

The proposal increases the EIC for workers without qualifying children by doubling the phase-in rate and the phase-out rate from 7.65 percent to 15.3 percent, thereby doubling the maximum credit such a taxpayer is eligible to receive.[431] The proposal increases the beginning of the phase-out range from an estimated $8,220 to $11,500 for 2015 (from $13,720 to $17,000 for joint filers). These values would continue to be indexed, as under present law. Based on those estimated values, under the proposal the EIC for workers with no children would be phased out completely at $18,070 for single taxpayers and $23,750 for married taxpayers filing jointly.

The proposal would also expand the age-eligibility to claim the EIC for those without children. The proposal would make individuals who are above age 20 and under age 25, as well as those individuals who are older than 64 but younger than 67, eligible to claim the EIC for taxpayers without children. The proposal retains the present-law rule providing that taxpayers who could be claimed as a qualifying child or a dependent on another taxpayer's return are not eligible for the EIC for taxpayers without children. Thus, under the proposal, full-time students who could be claimed as a dependent by their parents would not be allowed to claim the EIC for workers without children, even if the taxpayer's parents did not claim them as a dependent on their return.

An additional proposal would also simplify the EIC rules by allowing certain taxpayers who reside with a qualifying child that they do not claim to receive the EIC for workers without qualifying children.[432]

Effective date.−The proposal is effective for tax years beginning after December 31, 2014.

Analysis

The EIC for workers without qualifying children is generally structured to relieve the burden of Social Security taxes levied on low-income workers, while maintaining incentives to work. Proponents of the proposal to expand the credit for workers without qualifying children argue that current phaseout ranges and credit amounts are too low to provide adequate poverty relief for this group of taxpayers.

Proponents also note that currently, taxpayers without qualifying children who are 65 years of age or older are not eligible for the credit. They argue that this is inconsistent with recent increases in the Social Security full retirement age to 67 years.[433] Under current law, a

[431] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XI.A, reprinted in the back of this volume.

[432] For a description of this proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 657-660.

[433] It should be noted, however, that the increase of the "normal retirement age" to age 67 does not fully take effect until 2027, well beyond the proposal's effective date of January 1, 2015.

low-income taxpayer who does not have qualifying children and who is 65 or 66 years of age may be ineligible to receive both EIC and Social Security payments. Current age restrictions also prevent workers who are younger than 25 years from claiming the credit unless they have qualifying children. Proponents believe it is appropriate for younger workers with low incomes to take advantage of the work incentives and antipoverty benefits of the EIC even if they have no children. Proponents may further argue that expanding the no-child EIC would not significantly increase error rates among those who claim the EIC, as most of the complexity associated with claiming the EIC is associated with the eligibility of claimed children.

Furthermore, supporters of such a proposal may point to a large body of empirical evidence that the credit encourages unemployed workers to find employment, especially low-income single mothers. However, there is scant empirical evidence of workers adjusting hours worked in response to the policy.[434] As a result, opponents of the proposal to expand the EIC may note that, to the extent that childless workers, such as noncustodial fathers, already work, such an expansion may not result in a significant increase in labor supply.

B. Provide for Automatic Enrollment in Individual Retirement Accounts or Annuities (IRAs), Including a Small Employer Tax Credit, and Double the Tax Credit for Small Employer Plan Start-Up Costs

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 40-58. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XI.B, reprinted in the back of this volume.

C. Expand the Child and Dependent Care Tax Credit

Present Law

A taxpayer who maintains a household that includes one or more qualifying individuals may claim a nonrefundable credit against income tax liability for up to 35 percent of a limited amount of employment-related dependent care expenses. Eligible child and dependent care expenses related to employment are limited to $3,000 if there is one qualifying individual or $6,000 if there are two or more qualifying individuals. Thus, the maximum credit is $1,050 if there is one qualifying individual and $2,100 if there are two or more qualifying individuals. The applicable dollar limit is reduced by any amount excluded from income under an employer-provided dependent care assistance plan. The 35-percent credit rate is reduced, but not below 20 percent, by one percentage point for each $2,000 (or fraction thereof) of AGI above $15,000. Thus, for taxpayers with adjusted gross income above $43,000, the credit rate is 20 percent. The phase-out point and the amount of expenses eligible for the credit are not indexed for inflation.

[434] Nada Eissa and Hilary W. Hoynes, "Behavioral Responses to Taxes: Lessons from the EITC and Labor Supply," *Tax Policy and the Economy*, vol. 20, 2006, pp. 73-110.

Generally, a qualifying individual is: (1) a qualifying child of the taxpayer under the age of 13 for whom the taxpayer may claim a dependency exemption, or (2) a dependent or spouse of the taxpayer if the dependent or spouse is physically or mentally incapacitated, and shares the same principal place of abode with the taxpayer for over one half the year. Married taxpayers must file a joint return in order to claim the credit.

Description of Proposal

The proposal would modify the child and dependent care tax credit by providing for an additional credit for young children.[435] Under the proposal, eligible taxpayers would receive, in addition to the present-law child and dependent care credit, a credit on total expenses of up to $4,000 per child under age five, for up to two children. The credit rate for the additional young child credit would be 30 percent, and would phase down at a rate of one percentage point for every $2,000 (or part thereof) of AGI over $61,000 until the credit is fully phased out at AGI in excess of $119,000. Neither the expense limitation nor the phase out thresholds are indexed for inflation.

Effective date.−The proposal is effective for tax years beginning after December 31, 2014.

Analysis

The effect of the proposal is to increase the total value of the child and dependent care credit for taxpayers with children under age five. In the case of taxpayers with AGI below $15,000, if such a taxpayer has one child under age five, the first $3,000 in employment-related child care expenses would be creditable at a 65 percent rate ($1,950), and for such a taxpayer with two or more children under age five, $6,000 of such expenses would be creditable at a 65 percent rate ($3,900). Taxpayers with AGI up to $61,000 would receive a minimum credit of 50 percent of these same expenses. Taxpayers with AGI in excess of $61,000 would have their combined child and dependent care credit phased down to 20 percent at AGI in excess of $119,000.

This proposal represents an expansion of the child and dependent care tax credit. Any expansion of the credit may warrant consideration of the underlying theory of such a credit, and an evaluation if that expansion is consistent with the credit's underlying purpose. One can discern three rationales upon which providing a tax benefit for expenses associated with child and dependent care might be based.

Measurement of income.−Under this rationale, a taxpayer's child and dependent care expenses are viewed as income that is generally unavailable for consumption, and thus inappropriate to include in the tax base. A related rationale would be the view that such expenses are equivalent to an expense necessary for the production of income (*i.e.*, an expense

[435] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XI.C, reprinted in the back of this volume.

that is incurred in order to enable the taxpayer to work). Under either view, under an income tax with a progressive rate structure, the appropriate treatment of such expenses would be to provide a deduction from the taxpayer's gross income. Whether that deduction should be above-the-line (*i.e.*, without regard to whether the taxpayer takes the standard deduction or itemizes his or her deductions) or a below-the-line deduction depends on the value of the standard deduction and whether, in the judgment of policymakers, it is sufficient to encompass the expenses of child care for those taxpayers whose itemized deductions do not exceed the standard deduction.[436]

Encouraging workforce participation.−Under this rationale, a taxpayer's child and dependent care expenses should be subsidized by the Federal government because such a subsidy encourages second earners to enter the workforce.[437] If, for example, in the case of married taxpayers who filed their return jointly, the primary-earning spouse had income sufficient to place the taxpayers into the 25-percent tax bracket, the secondary-earning spouse would be taxed at 25 percent on the first dollar of income that spouse earned, in addition to payroll taxes on that income.[438] That tax burden (*i.e.*, the burden of having the first dollar of earnings taxed at the couple's highest marginal rate), plus the additional cost of child care paid so as to allow the secondary-earning spouse to work, may be so great as to render returning to work uneconomical. Implicit in this rationale is the notion that the secondary-earner's remaining out of the workforce to care for the taxpayers' dependents represents an inefficient allocation of resources.

The effectiveness of such a subsidy will depend on the level of the subsidy, the taxpayers' marginal tax rate, the earnings potential of the secondary-earning taxpayer, and the cost of child care. If one would abide purely by this rationale, the subsidy should increase as the primary-earning spouse's marginal tax rate increases (*i.e.*, the subsidy should increase for higher-income taxpayers), as a greater subsidy would be needed to overcome the additional tax expense incurred by the secondary-earning spouse. This would be achieved most easily with a deduction that was neither capped at a fixed dollar amount nor phased out. Additionally, under this rationale, it is not clear that unmarried filers should be eligible for such a subsidy (if the purpose is to encourage secondary-earners to join the workforce, presumably it is not necessary to provide a subsidy to a household's primary earner).[439]

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[436] Because the value of the standard deduction distinguishes those with dependents only in some circumstances (which is to say, individual filers with dependents have a larger standard deduction than individual filers with no dependents, but joint filers have the same standard deduction without regard to the presence of dependents), it seems difficult to argue that the standard deduction is meant to encompass the full extent of child and dependent care expenses. If so, joint filers without dependents garner a windfall benefit from the value of the standard deduction.

[437] In some cases the credit may encourage a head-of-household to return to work, such as in the case of a single parent who receives alimony and child support.

[438] The combined employee and employer share of Federal Insurance Contributions Act (FICA) tax is 15.3 percent.

[439] However, as previously noted, the child and dependent care credit may in some circumstances provide an incentive for unmarried parents to return to work in the case of those unmarried parents who are not working and supporting their family through the use of alimony and child support payments.

Income assistance to low and moderate income taxpayers.−A third rationale for such a tax benefit would be to provide financial assistance to low and moderate income taxpayers. Under this rationale, a tax benefit for child care expenses serves a function similar to that of the earned income tax credit or the child tax credit. However, it is unclear why child care expenses should, in and of themselves, trigger additional assistance to low income families, absent the presence of one of the two aforementioned rationales. Furthermore, to the extent that any tax benefit (other than in the case of refundable credits) is limited by a taxpayer's ability to reduce tax liability, financial assistance provided through the tax system necessarily excludes the lowest income taxpayers from the reaping the benefits of such a provision. Additionally, under such a rationale, we would expect any benefit for child care expenses to phase out completely as a taxpayer's income exceeded a certain level.

Congress has not articulated a clear rationale for the child and dependent care credit. Prior to the enactment of the Tax Reform Act of 1976, rather than a credit for child and dependent care expenses, taxpayers were eligible for an itemized deduction for such expenses.[440] The stated reasoning for the change from an itemized deduction to a tax credit does not provide a evidence of a clear choice among these rationales. The legislative history states:

> Treating child care expenses as itemized deductions denied any beneficial tax recognition of such expenses to taxpayers who elected the standard deduction. The Congress believed that such expenses should be viewed more as a cost of earning income than as personal expenses. One method for extending the allowance of child care expenses to taxpayers generally and not just to itemizers was to replace the itemized deduction with a credit against income tax liability for a percentage of qualified expenses. While deductions favor taxpayers in the higher marginal tax brackets, a tax credit provides relatively more benefit to taxpayers in the lower brackets.[441]

Although the intent of Congress, as described by the staff of the Joint Committee on Taxation, appears to be to treat such expenses as a "cost of earning income," the fact that Congress chose to provide taxpayers with a credit (rather than expanding the deduction, which

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[440] The itemized deduction was enacted in the Internal Revenue Code of 1954, Pub. L. No. 83-591, providing limited relief to taxpayers who were unable to deduct such expenses as a business expense (see *Smith v. Commissioner*, 40 BTA 1038 (1939)). In its original form, only certain taxpayers were eligible for the deduction: 1) working wives where the taxpayers filed a joint return and the taxpayers' combined AGI did not exceed $6,000; 2) working wives whose husbands were incapable of work because they were physically or mentally incapacitated; 3) widows and working women (other than wives) with children or incapacitated dependents; 4) widowers; and 5) husbands whose wives were incapacitated or institutionalized. The deduction was substantially liberalized to apply to all taxpayers who qualified (without regard to gender) in the Revenue Act of 1971, Pub. L. No. 92-178. Subsequently, a Federal Circuit Court declared the limited scope of the credit, as it existed prior to 1971 to be unconstitutional. See *Moritz v. Commissioner*, 469 F.2d 466 (10th Cir. 1972) (R.B. Ginsburg and M. Ginsburg arguing on behalf of petitioner-appellant).

[441] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976*, (JCS-33-76), December 29, 1976, p. 124.

would be more consistent with accommodating a "cost of earning income") suggests that Congress had mixed motives.

Indeed, the current form of the child and dependent care credit has elements of all three of the above-listed rationales. Because the credit applies only to child and dependent care expenses that are incurred so as to pursue gainful employment, the credit represents more than income assistance to low-income taxpayers. However, the credit is not obviously intended to properly measure income, as child and dependent care expenses upon which the credit is based are capped, and the subsidy is provided as a credit whose percentage is determined without regard to the taxpayer's marginal tax bracket. Furthermore, the credit is not obviously intended to encourage a second-earning spouse to return to work, given that the credit does not increase as taxpayers' marginal tax rate increases, and is available for non-joint filers.

If one believes that the intent of the child and dependent care credit is to reduce gross income by child care expenses, either because those expenses are deemed unavailable for the taxpayer's consumption or because such expenses are necessary for gainful employment, the President's proposal appears to provide a greater financial subsidy than would be appropriate under such a policy. As described above, low-income taxpayers with small children would receive a 65-percent credit on their child care expenses under the proposal. This is significantly higher than the marginal Federal income tax rate faced by such low-income taxpayers, which likely does not exceed 25 percent.[442]

By targeting taxpayers with children under five years of age, the proposal focuses on a segment of taxpayers that may have particularly high employment-related child care expenses, because these children are generally too young to attend elementary school. By increasing the after-tax return to employment for non-working individuals with child care responsibilities, the proposal could further encourage these individuals to seek work outside of the home.

By increasing the value of the credit for taxpayers with young children, the proposal reduces net cost of child care for those taxpayers and, thereby, does provide income assistance to low and moderate income taxpayers. Because the proposal phases the credit down as a taxpayer's AGI increases, the reduction of the net costs of childcare is focused primarily on low and middle income taxpayers. However, if income assistance is a primary policy goal, it should be noted that a limitation of both present-law and the President's proposal is that the credit can provide a benefit only to those taxpayers having a tax liability; low-income taxpayers with no tax liability cannot benefit from the credit.

D. Extend the Exclusion from Income for Cancellation of Certain Home Mortgage Debt

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget*

[442] For a tax credit to have the same economic effect as an above-the-line deduction from gross income, that tax credit should be provided at the taxpayer's marginal tax rate.

Proposal (JCS-2-12), June 2012, pp. 64-66. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XI.D, reprinted in the back of this volume.

E. Provide Exclusion from Income for Student Loan Forgiveness for Students in Certain Income-Based or Income-Contingent Repayment Programs Who Have Completed Payment Obligations

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 67-69. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XI.E, reprinted in the back of this volume.

F. Provide Exclusion from Income for Student Loan Forgiveness and for Certain Scholarship Amounts for Participants in the Indian Health Service Health Professions Programs

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 70-72. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XI.F, reprinted in the back of this volume.

G. Make Pell Grants Excludable From Income and From Tax Credit Calculations

Present Law

Credits for higher education expenses

Hope credit and American Opportunity credit

For taxable years beginning before 2009 and after 2017, individual taxpayers are allowed to claim a nonrefundable credit, the Hope credit, against Federal income taxes of up to $1,950 (estimated 2014 level) per eligible student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program.[443] The Hope credit rate is 100 percent on the first $1,300 of qualified tuition and related expenses, and 50 percent on the next $1,300 of qualified tuition and related expenses.

[443] Sec. 25A(a)(1).

These dollar amounts are indexed for inflation, with the amount rounded down to the next lowest multiple of $100. Thus, for example, a taxpayer who incurs $1,300 of qualified tuition and related expenses for an eligible student is eligible (subject to the adjusted gross income ("AGI") phaseout described below) for a $1,300 Hope credit. If a taxpayer incurs $2,600 of qualified tuition and related expenses for an eligible student, then he or she is eligible for an $1,950 Hope credit.

The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $55,000 and $65,000 ($110,000 and $130,000 for married taxpayers filing a joint return) for 2014, based on inflation adjustments determined by the staff of the Joint Committee on Taxation. The beginning points of the AGI phaseout ranges are indexed for inflation, with the amount rounded down to the next lowest multiple of $1,000. The size of the phaseout ranges for single and married taxpayers are always $10,000 and $20,000 respectively.

For taxable years beginning after December 31, 2008, individual taxpayers are eligible to claim the American Opportunity credit, which refers to modifications to the Hope credit that apply for taxable years 2009 through 2017.[444] The maximum allowable modified credit is $2,500 per eligible student per year for qualified tuition and related expenses paid for each of the first four years of the student's post-secondary education in a degree or certificate program. The modified credit rate is 100 percent on the first $2,000 of qualified tuition and related expenses, and 25 percent on the next $2,000 of qualified tuition and related expenses. For purposes of the modified credit, the definition of qualified tuition and related expenses is expanded to include course materials. Forty percent of a taxpayer's otherwise allowable modified credit is refundable. The modified credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $80,000 and $90,000 ($160,000 and $180,000 for married taxpayers filing a joint return). The modified credit may be claimed against a taxpayer's AMT liability.

The Hope and American Opportunity credits are available for qualified tuition and related expenses, which include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of an eligible student at the institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student's degree program.

Qualified tuition and related expenses generally include only out-of-pocket expenses. Qualified tuition and related expenses do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student (or the taxpayer claiming the credit) during the taxable year. The Hope and American Opportunity

[444] Sec. 25A(i).

credit are not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

Lifetime learning credit

Individual taxpayers may be eligible to claim a nonrefundable credit, the Lifetime Learning credit, against Federal income taxes equal to 20 percent of qualified tuition and related expenses incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or any dependents. Up to $10,000 of qualified tuition and related expenses per taxpayer return are eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return is $2,000). In contrast with the Hope and American Opportunity tax credits, the maximum credit amount is not indexed for inflation.

In contrast to the Hope and American Opportunity tax credits, a taxpayer may claim the Lifetime Learning credit for an unlimited number of taxable years.[445] Also in contrast to the Hope and American Opportunity tax credits, the maximum amount of the Lifetime Learning credit that may be claimed on a taxpayer's return does not vary based on the number of students in the taxpayer's family—that is, the Hope and American Opportunity credits are computed on a per student basis while the Lifetime Learning credit is computed on a family-wide basis. The Lifetime Learning credit amount that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $55,000 and $65,000 ($110,000 and $130,000 for married taxpayers filing a joint return) in 2014. These phaseout ranges are the same as those for the Hope credit as it applies for tax years beginning before 2009, and are similarly indexed for inflation.

Qualified tuition and related expenses for purposes of the Lifetime Learning credit include tuition and fees incurred with respect to undergraduate or graduate-level courses.[446] As with the Hope and American Opportunity tax credits, qualified tuition and fees generally include only out-of-pocket expenses. Qualified tuition and fees do not include expenses covered by employer-provided educational assistance and scholarships that are not included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and fees are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student during the taxable year (such as employer-provided educational assistance excludable under section 127). The Lifetime Learning credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

[445] Sec. 25A(a)(2).

[446] As explained above, the Hope credit is available only with respect to the first two years of a student's undergraduate education. The American Opportunity tax credit is available only with respect to the first four years of a student's post-secondary education.

Pell Grants

The Federal Pell Grant Program provides need-based grants to low-income undergraduate and certain post-baccalaureate students to promote access to postsecondary education. The maximum Pell Grant for the 2014-2015 award year is $5,730. Federal student aid, including Pell Grants, can be used to cover a variety of costs, including tuition and fees, books, supplies, transportation, living expenses such as room and board; and an allowance for costs expected to be incurred for dependent care for a student with dependents.

Treatment of scholarships and fellowship grants

Present law provides an exclusion from gross income and wages for amounts received as a qualified scholarship by an individual who is a candidate for a degree at a qualifying educational organization.[447] Generally, the exclusion does not apply to amounts received by a student that represent payment for teaching, research, or other services by the student as a condition for receiving the scholarship.

In general, a qualified scholarship is any amount received by such an individual as a scholarship (including a Pell Grant) or fellowship grant if the amount is used for qualified tuition and related expenses. Qualified tuition and related expenses include tuition and fees required for enrollment or attendance, or for fees, books, supplies, and equipment required for courses of instruction, at the qualifying educational organization. This definition does not include regular living expenses, such as room and board. A qualifying educational organization is an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.

Description of Proposal

The proposal would modify the tax treatment of Pell Grants. Under the proposal, Pell Grants would be excludable from a taxpayer's gross income without regard to which expenses the Pell Grant funds were applied, so long as the proceeds are spent in accordance with the Pell Grant program.[448]

Additionally, the proposal would modify the rule in the Hope, AOTC and Lifetime Learning credits such that taxpayers would be able to treat the entire amount of the Pell Grant as used to pay expenses other than qualified tuition and related expenses. The effect of this provision is to reduce the amount by which a taxpayer would otherwise be required to reduce his or her qualified tuition amount (because the entirety of the Pell Grant, under the proposal

[447] Secs. 117(a), 3121(a)(20).

[448] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XI.G, reprinted in the back of this volume.

described above, would now be excluded from income). This in effect provides for a "stacking" rule, ensuring that Pell Grants are deemed first to cover non-tuition expenses.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2014.

Analysis

The effect of the proposal is to lower the cost of college attendance for those students receiving Pell Grants. The proposal accomplishes this in two ways. For those students who use Pell Grant funds to pay for items other than tuition, fees, and other items that are eligible expenses for purposes of the education-related tax credits, the proposal would exempt the Pell amounts from tax. Thus, the cost of attending college would be reduced by the amount of tax that would otherwise be imposed on these Pell Grant funds. For those students who make use of the Pell Grant funds by applying those funds towards tuition, fees, and other credit-eligible expenses, the proposal provides that the student no longer need deduct these amounts from the amount of qualified tuition paid, for purposes of computing the credit. Because the resulting reported tuition paid will be higher, a student's tax credit measured against this amount may be higher.

Proponents of the proposal may observe that the cost of post-secondary education has increased at a rate in excess of the rate of inflation for nearly 35 years, with the result that it is becoming an ever greater financial burden for individuals to pursue a college education. Proponents may thus contend that increasing the net after tax value of Pell Grants and the various education tax credits will help to mitigate some of this burden. Additionally, the provision of the proposal that coordinates Pell grant funds used for tuition and fees with Pell grant funds that are used for other non-tuition expenses may provide simplification for taxpayers who currently need to determine the most tax-efficient way to allocate these funds.

A potential criticism of the proposal is that the proposal favors Pell Grants over other scholarships, and thus creates a horizontal inequity between taxpayers who fund their education through means other than a Pell Grant and taxpayers who receive Pell Grants. For instance, if a taxpayer receives a scholarship from the college they are attending, the taxpayer's tuition payment is reduced for purposes of computing the relevant education-related tax credit. Under the proposal, a taxpayer who received the same amount of aid in the form of a Pell Grant would not need to reduce reported tuition paid, and would thus potentially receive a higher credit. Similarly, a scholarship from a college is taxable to the extent it exceeds tuition and fees, but under the proposal a Pell Grant would not be taxable even if it was in excess of tuition and fees. It is not clear why the tax law would impose differential treatment for these two otherwise similarly situated taxpayers. A potential response to this criticism could be that Pell Grants are awarded only to students who have demonstrated a financial need, whereas scholarships other than Pell Grants are at times granted to students based on academic merit or athletic ability rather than financial need.

PART XII − UPPER-INCOME TAX PROVISIONS

A. Reduce the Value of Certain Tax Expenditures

This proposal is substantially similar to a proposal found in last year's budget proposal. Last year's proposal was a modification of the prior year's proposal. That modification is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 98, and the original proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 219-228. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XII.A, reprinted in the back of this volume.

B. Implement the Buffett Rule by Imposing a New "Fair Share Tax"

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 99-102. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XII.B, reprinted in the back of this volume.

PART XIII − MODIFY ESTATE AND GIFT TAX PROVISIONS

A. Restore the Estate, Gift, and Generation-Skipping Transfer (GST) Tax Parameters in Effect in 2009

This proposal is substantially similar to a proposal found in last year's budget proposal. Last year's proposal was a modification of the prior year's proposal. That modification is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 103, and the original proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 769-796. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XIII.A, reprinted in the back of this volume.

B. Require Consistency in Value for Transfer and Income Tax Purposes

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 256-259. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XIII.B, reprinted in the back of this volume.

C. Require a Minimum Term for Grantor Retained Annuity Trusts

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 269-273. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XIII.C, reprinted in the back of this volume.

D. Limit Duration of Generation-Skipping Transfer (GST) Tax Exemption

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 274-281. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XIII.D, reprinted in the back of this volume.

E. Coordinate Certain Income and Transfer Tax Rules Applicable to Grantor Trusts

For a description of this proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 282-293, and a modification described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 104-105. The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XIII.E, reprinted in the back of this volume.

F. Extend the Lien on Estate Tax Deferrals Where Estate Consists Largely of Interest in Closely Held Business

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 294-298. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XIII.F, reprinted in the back of this volume.

G. Modify Generation-Skipping Transfer (GST) Tax Treatment of Health and Education Exclusion Trusts

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 106-110. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XIII.G, reprinted in the back of this volume.

H. Simplify Gift Tax Exclusion for Annual Gifts

Present Law

Gift tax annual exclusion

Under present law, gift tax is imposed on transfers of property by gift, subject to several exceptions. One major exception is the gift tax annual exclusion of section 2503(b). Under this exclusion, a donor can transfer up to $14,000 of property to each of an unlimited number of donees without incurring gift tax on such transfers.[449] To qualify for the exclusion, the property

[449] The statute provides an amount of $10,000, adjusted in $1,000 increments for inflation occurring after 1997. The inflation-adjusted amount for 2014 is $14,000.

interests transferred must be present interests, as opposed to future interests (such as remainders). In addition, spouses are allowed to "split" gifts for purposes of applying the exclusion.[450] For example, at both spouses' election, a $28,000 gift from one spouse to a third person could be treated as being made equally by both spouses, and thus would be sheltered entirely by the spouses' combined annual exclusion amounts.

Gifts in trust; Crummey powers

Gifts in trust are treated as made to the trust beneficiaries for purposes of applying the annual exclusion.[451] Accordingly, if the trust beneficiaries have no right to the present enjoyment of the transferred property, the annual exclusion does not apply, as no present interest was transferred. However, the courts and the IRS have long agreed that a temporary right of withdrawal of trust property on the part of a beneficiary may serve to create a present interest, thus qualifying such a gift for the annual exclusion. This result obtains even if the right of withdrawal is of short duration, and even if all parties involved expect that the right will not be exercised, and thus the beneficiary will not actually "enjoy" the transferred property on a current basis as a practical matter.[452] For example, a married couple may establish a trust for the benefit of their minor child, and the general terms of the trust may allow distributions to the child only upon reaching age 25. This couple nevertheless can transfer $28,000 per year to the trust, fully shielded by the annual exclusion, as long as the child is given a temporary power to demand distribution of each new amount transferred into the trust, even if it is highly improbable that the power will be exercised. These powers, and these arrangements in general, are referred to as "Crummey powers," and "Crummey trusts" (so named after a court case upholding one such arrangement).

While Crummey powers may be used in connection with simple transfers of cash or any other kind of asset into a trust, use of the powers is particularly common in the case of life insurance trusts. In these arrangements, an irrevocable trust owns the life insurance policy,[453] the insured makes periodic payments into the trust for the purpose of covering the premiums, and the trust beneficiaries are given Crummey powers with respect to these periodic payments, in order to ensure that the payments qualify as transfers of present interests eligible for the gift tax annual exclusion.

Taxpayers have used Crummey powers to achieve benefits extending beyond the conversion of future interests into present interests. Specifically, taxpayers have taken the position that the holder of the Crummey power need not even be a vested beneficiary of the trust, which creates the possibility of using multiple annual exclusions (one for each Crummey power

[450] See section 2513.

[451] See *Helvering v. Hutchings,* 312 U.S. 393 (1941).

[452] See *Crummey v. Commissioner,* 397 F.2d 82 (9th Cir. 1968); Rev. Rul. 73-405, 1973-2 C.B. 321.

[453] By arranging ownership of the policy by an irrevocable trust rather than retaining ownership of the policy, the grantor/insured may avoid inclusion of the insurance proceeds in his or her gross estate upon death, and thereby avoid estate taxation of the proceeds.

holder) for what ultimately will be a gift to a single donee, as a practical matter. The Tax Court has sustained this position.[454]

Description of Proposal

The proposal eliminates the present interest requirement for gifts to qualify for the gift tax annual exclusion. Instead, the proposal defines a new category of transfers (without regard to the existence of any withdrawal or put rights), and imposes an annual limit of $50,000 per donor on such transfers by the donor that will qualify for the gift tax annual exclusion.[455] Thus, a donor's transfers in the new category in a single year in excess of a total amount of $50,000 are taxable, even if the total gifts to each individual donee do not exceed $14,000. The new category includes transfers in trust (other than to a trust described in section 2642(c)(2)), transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee.

Effective date.−The proposal is effective for gifts made after the year of enactment.

Analysis

Simplify compliance and enforcement

The use of Crummey powers to satisfy the present interest requirement is widespread. The compliance costs can be significant, with many taxpayers engaging attorneys to draft and send timely Crummey notices to trust beneficiaries each time amounts are transferred to a trust, such as to fund periodic premiums for a life insurance policy owned by the trust. Enforcing the present interest requirement also places substantial resource burdens on the IRS.

The complexity involved with Crummey powers also can lead to uncertainty for taxpayers. As the Treasury Department points out in its description of the proposal, if the appropriate records cannot be produced at the time of any gift or estate tax audit of the grantor, the gift tax exclusion may be denied to the grantor, thereby causing retroactive changes in the grantor's tax liabilities and remaining lifetime gift and estate tax exemptions.

The proposal attempts to address the above policy concerns by removing the present interest requirement and allowing up to $50,000 per donor per year in certain gifts that fall within a new, defined category of transfers that under present law generally would not be gifts of present interests. More specifically, transfers subject to the $50,000 cap include: transfers in trust (other than to a trust described in section 2642(c)(2)), transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers of property that,

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[454] See *Estate of Cristofani v. Commissioner,* 97 T.C. 74 (1991).

[455] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XIII.H, reprinted in the back of this volume.

without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee. Outright transfers (*i.e.*, not in trust) generally are not subject to the $50,000 cap. In other words, taxpayers could continue to make outright transfers each year in amounts up to $14,000 (indexed) to an unlimited number of recipients.

Because the present interest requirement is eliminated under the proposal, taxpayers no longer would need to use Crummey powers to create a present interest where one otherwise would not exist, substantially simplifying compliance with the law. Such transfers, (*e.g.*, to an irrevocable life insurance trust to fund premium payments), automatically would qualify for the annual exclusion, provided the total amount of such transfers does not exceed $50,000.[456] As a result, taxpayers' paperwork burdens and compliance costs would be reduced. In addition, the IRS would no longer need to police the sufficiency of Crummey powers or the timeliness of notices to beneficiaries informing them of withdrawal rights, which simplifies the IRS's administration of the annual exclusion. The IRS then could more productively allocate these enforcement resources.

Prevent abuse

The legislative history to the gift tax annual exclusion indicates that its size initially was established to exempt from gift tax numerous small gifts and larger wedding and Christmas gifts.[457] Nothing in the legislative history, however, indicates that Congress contemplated the use of techniques intended solely to convert non-present interest transfers into gifts of present interests for purposes qualifying for the annual exclusion. By eliminating the present interest requirement and capping the amount of transfers that qualify for the annual exclusion under the new category, the proposal seeks to end the practice of manufacturing present interests by using Crummey powers.

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[456] As discussed in greater detail below, this analysis assumes that transfers within the new category also are subject to the present-law per-donee limit (currently $14,000 per year), although the Treasury Department's written description of the proposal is ambiguous in this regard.

[457] The Finance Committee report for the Revenue Act of 1932 (S. Rept. No. 665, 72d Cong., 1st Sess., 41) states as follows:

> Such exemption, on the one hand, is to obviate the necessity of keeping account of and reporting numerous small gifts, and, on the other, to fix the amount sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts. The exemption does not apply with respect to a gift to any donee to whom is given a future interest. The term "future interest in property" refers to any interest or estate, whether vested or contingent, limited to commence in possession or enjoyment at a future date. The exemption being available only in so far as the donees are ascertainable, the denial of the exemption in the case of future interests is dictated by the apprehended difficulty, in many instances, of determining the number of eventual donees and the value of their respective gifts.

Identical language is contained in the Report of the Committee on Ways and Means (H. Rept. No. 708, 72nd Cong., 1st Sess., 29).

The use of Crummey powers often is a legal fiction, because, typically by understanding or expectation, it is extremely rare for a Crummey power to be exercised. Although Crummey powers are often essentially shams, they are for the most part respected for gift tax purposes. The proposal thus is laudable in attempting to address this concern. Those opposed to the proposal, however, might assert that taxpayers have been making use of Crummey powers to minimize gift taxes with respect to certain transfers to trusts for over 40 years and that such established principles of gift tax planning should not be eliminated.

Crummey powers arguably are particularly objectionable − and potentially more abusive − when the powers are used to claim multiple annual exclusions in connection with gifts that are intended and arranged to accrue to a single person, as occurred in the *Cristofani* case. This is sometimes accomplished by granting several friendly accommodation parties − who are not expected to exercise withdrawal rights, and who otherwise have no direct economic interest in the trust − Crummey powers with respect to a trust that is intended to benefit someone else, such as a child of the grantor. This power to mint annual exclusions is limited only by the number of friends and relatives a donor can find and can trust not to exercise the withdrawal right during its brief existence, potentially resulting in significant erosion of the tax base.

As an example, assume that a taxpayer establishes an irrevocable trust that owns a large life insurance policy, with her son named as beneficiary of the trust. The annual insurance premium is $28,000, and the grantor wishes to transfer cash to the trust sufficient to enable the trustee to make a premium payment. In the absence of Crummey powers, the transfer of cash is treated as a gift of a future interest in property to the son. Because the transfer does not satisfy the present interest requirement, the transfer does not qualify for the annual exclusion; the grantor therefore must pay gift tax on the transfer or, if not already exhausted, use a portion of her lifetime exemption from gift tax. If instead the son is given a temporary, lapsing right to withdraw the cash from the trust (*i.e.*, a Crummey power), the transfer is treated as a transfer of a present interest for purposes of the annual exclusion, such that $14,000 of the $28,000 transfer qualifies for the annual exclusion.[458] If a close friend of the family also is given a Crummey power, the entire $28,000 might qualify for the annual exclusion − $14,000 attributed to each of her son and the friend − even though the friend has no direct, economic interest in the trust.

As mentioned above, the legislative history provides explicitly that Congress initially set the annual exclusion at a level intended to exempt only certain smaller gifts and larger wedding and Christmas gifts from gift tax. It is therefore unlikely that Congress considered at that time − or would have approved of − taxpayers engaging in *Cristofani*-style transactions that provide withdrawal rights to friendly accommodation parties to generate multiple exclusions. This technique has been used to exempt from gift tax transfers with a value equal to many multiples of the annual exclusion, far in excess of amounts typically spent on the types of gifts Congress had in mind when it first enacted the annual exclusion. The IRS has sought to limit the number of available Crummey powers by requiring each power-holder to have some meaningful vested

[458] A married taxpayer who splits gifts with a spouse could claim double the per-donee annual exclusion amount for each exclusion claimed and more quickly increase the total amount of exclusions using the strategy outlined in this example.

economic interest in the trust over which the power extends.[459] But so far the IRS has been unsuccessful in imposing such a limit.

The above-cited legislative history also supports the view that the disallowance of the annual exclusion for future interests was necessary because of the need to determine the identity of the donee and the amount of the gift. Elimination of the present-interest requirement arguably is inconsistent with this rationale. This concern, however, is at least partially mitigated under the proposal by subjecting the total amount of non-present interest transfers that fall within the new category to an overall, annual cap of $50,000.

Possible need for clarification

Interaction between $50,000 new category and $14,000 per-donee limit

Several practitioners interpret the proposal as allowing taxpayers a $50,000 pot of "mad money" for transfers described in the new category, separate from and unrestricted by the present-law $14,000 (indexed for inflation) annual per-donee limit.[460] Under such a reading, an unmarried taxpayer could transfer as much as $64,000 per year (for 2014) to or for the benefit of one individual − $50,000 in trust (or through one of the other types of transfers subject to the new $50,000 cap) plus $14,000 in direct transfers.

It is our understanding, however, that the Treasury Department intends for the present-law $14,000 (for 2014) per-donee limit to remain in effect for all transfers to a donee, whether or not the transfers are of a type that fall within the new $50,000 per-donor limit. Thus, for example, a taxpayer who wishes to make annual exclusion gifts in trust for the benefit of her son is limited to $14,000 in such transfers in a year. The taxpayer cannot use the full $50,000 per-donor allocation for transfers to a single beneficiary. Nor can a taxpayer who has made $14,000 in new-category annual exclusion transfers (such as transfers in trust) for the benefit of one beneficiary make additional, direct transfers to the same person and qualify those transfers for the annual exclusion.

Although we have assumed that the $14,000 annual per-donee limit of present law will continue to apply independently of, and as an overlay to, the new $50,000 per-donor limit on new-category transfers, because there appears to be considerable confusion among estate and gift planning practitioners, the Treasury Department should clarify its intent.

Inflation indexing

The proposal does not provide for the new $50,000 amount to be adjusted for inflation in future years, and we have assumed for purposes of this analysis that it would not be adjusted.

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[459] See *Estate of Cristofani v. Comm'r*, 97 T.C. 74 (1991); *Kohlsaat v. Comm'r*, 73 TCM 2732 (1997).

[460] See, *e.g.*, Ronald D. Aucutt, *Still Another Assault on Crummey Powers*, American College of Trust and Estate Counsel, Capital Letter No. 35, March 31, 2014, *available at* http://www.actec.org/public/CapitalLetter35.asp (noting that the interaction of the new $50,000 category of transfers and the present-law $14,000 per-donee limit is unclear under the proposal and describing various possible interpretations).

Particularly because the annual per-donee exclusion is adjusted periodically for inflation, some practitioners have questioned whether the $50,000 per-donor amount also should be periodically adjusted. If it is the Treasury Department's intent that the $50,000 amount should be adjusted for inflation in future years, this intent should be clarified.

Transition relief

The proposal is effective for gifts made after the year of enactment. The proposal does not provide a special transition rule for existing arrangements. As a result, for example, if a taxpayer previously established an irrevocable life insurance trust in or before the year of enactment and wishes to make transfers of cash to the trust to fund premiums in years after the date of enactment, the new rules of the proposal would apply to these transfers.

Some may argue that this is a harsh result for arrangements that cannot now be changed and that the Treasury Department thus should provide a grandfather rule for existing, irrevocable arrangements. To the extent the effect of the proposal in such instances largely would be to prevent abuse of the tax laws (such as the minting of multiple annual exclusions), such arguments may not be especially persuasive. Transitional relief may nevertheless be appropriate in situations where the insurance policy is a whole life policy, especially where the policy has been irrevocably transferred to the trust and the insured individual is no longer insurable.

Other possible approaches

The use of Crummey powers to qualify transfers for the annual exclusion is not a new concern. In fact, it has been the subject of several past legislative proposals, each somewhat different from the fiscal year 2015 budget proposal.

In its fiscal year 2001 budget, for example, the Clinton Administration included a proposal to eliminate the use of Crummey powers and to subject the gift tax annual exclusion to the same rules that apply for generation-skipping transfer tax direct skips.[461] Thus, the gift tax annual exclusion would not apply to a transfer to a trust for the benefit of an individual unless (1) during the life of the individual, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than such individual, and (2) if the trust does not terminate before the beneficiary dies, then the assets of such trust will be includible in the gross estate of such individual. No notice of withdrawal right would be necessary for a transfer to such a trust to qualify for the annual exclusion. The Clinton Administration made a similar proposal for fiscal year 1999.

In 2005, the staff of the Joint Committee on Taxation suggested three alternative ways to address concerns about Crummey powers.[462] Under the first option, for purposes of determining

[461] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals*, February 2000, pp. 186-187. For a discussion of this proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal* (JCS-2-00), March 6, 2000, pp. 457-461.

[462] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005, pp. 405-408. The proposal was part of a report prepared by the Joint Committee staff in

the applicability of the annual exclusion, a holder of a Crummey power is not treated as the donee with respect to an amount transferred into trust unless such holder is also a direct, noncontingent beneficiary of the trust. This option would eliminate the *Cristofani*-style transactions under which multiple annual exclusions are used for transfers intended to benefit a single person. Under the second option, powers to demand the distribution of trust property are taken into account only if they cannot lapse during the holder's lifetime. This option effectively eliminates Crummey powers as a tax planning tool. Under the third option, powers to demand the distribution of trust property are taken into account only if: (1) there is no arrangement or understanding to the effect that the powers will not be exercised; and (2) there exists at the time of the creation of such powers a meaningful possibility that they will be exercised. This option requires a facts-and-circumstances analysis of every Crummey power and disregards those that are found to be essentially lacking in substance. In view of the prevalence of Crummey powers that essentially lack substance, the practical effect of this option would be to eliminate Crummey powers as a planning tool in a wide range of cases.

I. Expand Applicability of Definition of Executor

Present Law

The Code defines the term "executor," for the limited purposes of the estate tax, to be the person who is appointed, qualified, and acting within the United States as executor or administrator of the decedent's estate or, if none, then "any person in actual or constructive possession of any property of the decedent."[463] This could include, for example, the trustee of the decedent's revocable trust, the beneficiary of an individual retirement arrangement or life insurance policy, or a surviving joint tenant of jointly owned property. The Code does not define the term "executor" for purposes of the gift or income taxes.

Description of Proposal

To empower an authorized party to act on behalf of the decedent in all matters relating to the decedent's tax liability, the proposal expressly makes the Code's definition of executor applicable for all tax purposes, and authorizes such executor to do anything on behalf of the decedent in connection with the decedent's pre-death tax liabilities or obligations that the decedent could have done if still living.[464] In addition, the proposal grants regulatory authority to adopt rules to resolve conflicts among multiple executors authorized by the proposal.

Effective date.−The proposal is effective on the date of enactment, regardless of a decedent's date of death.

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response to a request from the Chairman and Ranking Member of the Senate Committee on Finance to propose ways to reduce the size of the tax gap by addressing areas of noncompliance with the tax laws.

[463] Sec. 2203.

[464] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XIII.I, reprinted in the back of this volume.

Analysis

Because the Code's definition of executor currently applies only for purposes of the estate tax, no one has the express authority to act on behalf of the decedent with regard to a tax liability that arose prior to the decedent's death. This includes, for example, a surviving spouse who filed a joint income tax return with the decedent prior to the decedent's death. By extending the use of the Code's definition of executor for other tax law purposes, the proposal has the laudable goal of simplifying compliance with and administration of the tax laws by lending consistency to the laws.

According to the Treasury Department, the lack of clear rules regarding the full extent of an executor's authority under current law can create confusion or complicate survivors' or an executor's ability to address a wide range of income tax issues or to take required action. Such actions might include, for example, extending the statute of limitations, claiming a refund, agreeing to a compromise or assessment, or pursuing judicial relief in connection with the decedent's share of a tax liability.

Furthermore, as reporting obligations have increased over time, this concern has been magnified. As an example, the increased reporting obligations with respect to a foreign asset or account and the recent voluntary disclosure initiatives by the Internal Revenue Service highlight the difficulties survivors may encounter as they attempt to resolve a decedent's failure to comply.[465]

The Treasury Department also notes that administrative confusion can arise where multiple persons meet the definition of an executor under the Code. This could, for example, lead to more than one claimed executor of a decedent filing an estate tax return or making conflicting tax elections. By providing regulatory authority to adopt rules to resolve such conflicts, the proposal arguably would improve administration of the tax laws.

[465] The Hiring Incentives to Restore Employment Act of 2010, Pub. L. No. 111-147, generally requires individuals to disclose with their annual Federal income tax return any interest in foreign accounts and certain foreign securities if the aggregate value of such assets is in excess of $50,000. Failure to do so can result in significant penalties. Additionally, U.S. persons with foreign holdings may be required to file an annual form TDF 90-22.1, Foreign Bank Account Report. The Internal Revenue Service has introduced offshore voluntary compliance initiatives to encourage the voluntary disclosure of previously unreported income in offshore accounts. Under these programs, the Internal Revenue Service waived certain penalties relating to failure to file information and other returns.

PART XIV − REFORM TREATMENT OF FINANCIAL INDUSTRY INSTITUTIONS AND PRODUCTS

A. Impose a Financial Crisis Responsibility Fee

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 432-448. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XIV.A, reprinted in the back of this volume.

B. Require Current Inclusion in Income of Accrued Market Discount and Limit the Accrual Amount for Distressed Debt

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 111-112. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XIV.B, reprinted in the back of this volume.

C. Require that the Cost Basis of Stock that is a Covered Security Must be Determined Using an Average Basis Method

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 113-117. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XIV.C, reprinted in the back of this volume.

PART XV ─ LOOPHOLE CLOSERS

A. Tax Carried (Profits) Interests as Ordinary Income

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 538-552. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XV.A, reprinted in the back of this volume.

B. Require Non-Spouse Beneficiaries of Deceased Individual Retirement Account or Annuity (IRA) Owners and Retirement Plan Participants to Take Inherited Distributions Over No More than Five Years

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 128-135. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XV.B, reprinted in the back of this volume.

C. Limit the Total Accrual of Tax-Favored Retirement plans

Description of Modification

The fiscal year 2014 budget proposal is modified to specify that regulations would provide for simplified reporting for defined benefit plans.[466] The proposal includes as one example of such simplify reporting that a sponsor of a cash balance plan would be permitted to treat a participant's hypothetical account balance under the plan as an accumulated account balance under a defined contribution plan for purposes of reporting under the proposal. The proposal indicates that it is anticipated that other simplifications would be considered in order to ease administration.

[466] The fiscal year 2014 budget proposal is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 136-154. The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), Item X.V.C, reprinted in the back of this volume.

D. Conform Self-Employment Contributions Act (SECA) Taxes for Professional Service Businesses

Present Law

In general

As part of the financing for Social Security and Medicare benefits, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal Insurance Contributions Act ("FICA").[467] A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act ("SECA").[468]

FICA

The FICA tax has two components. Under the old-age, survivors, and disability insurance component ("OASDI"), the rate of tax is 12.4 percent, half of which is imposed on the employer, and the other half of which is imposed on the employee.[469] The amount of wages subject to this component is capped at $117,000 for 2014. Under the hospital insurance ("HI") component, the rate is 2.9 percent, also split equally between the employer and the employee. The amount of wages subject to the HI component of the tax is not capped. Beginning 2013, the employee portion of the HI tax under FICA (not the employer portion) is increased by an additional tax of 0.9 percent on wages received in excess of a threshold amount.[470] The wages of individuals employed by a business in any form (for example, a C corporation) generally are subject to the FICA tax. The employee portion of the FICA tax is collected through withholding from wages.[471]

SECA

The SECA tax rate is the combined employer and employee rate for FICA taxes. Under the OASDI component, the rate of tax is 12.4 percent and the amount of earnings subject to this component is capped at $117,000 for 2014. Under the HI component, the rate is 2.9 percent, and the amount of self-employment income subject to the HI component is not capped. Beginning

[467] See Chapter 21 of the Code.

[468] Sec. 1401.

[469] Secs. 3101 and 3111.

[470] The threshold amount is $250,000 in the case of a joint return, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. Sec. 3101(b).

[471] Sec. 3102.

2013, an additional 0.9 percent HI tax applies to self-employment income in excess of a threshold amount.[472]

For SECA tax purposes, net earnings from self-employment generally includes the gross income derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the self-employment tax rules.[473] Net earnings from self-employment generally includes the distributive share of income or loss from any trade or business of a partnership in which the individual is a partner.

Specified types of income or loss are excluded, such as rentals from real estate in certain circumstances, dividends and interest, and gains or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers.

S corporation shareholders

An S corporation is treated as a passthrough entity for Federal income tax purposes. Each shareholder takes into account and is subject to Federal income tax on the shareholder's pro rata share of the S corporation's income.[474]

A shareholder of an S corporation who performs services as an employee of the S corporation is subject to FICA tax on his or her wages from the S corporation. A shareholder of an S corporation generally is not subject to FICA tax on amounts that are not wages, such as the shareholder's share of the S corporation's income.

An S corporation shareholder's pro rata share of S corporation income is not subject to SECA tax.[475] Nevertheless, courts have held that an S corporation shareholder is subject to FICA tax on the amount of his or her reasonable compensation, even though the amount may have been characterized by the taxpayer as other than wages. The case law has addressed the issue of whether amounts paid to shareholders of S corporations constitute reasonable

[472] The threshold amount is $250,000 in the case of a joint return, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. Sec. 1401(b).

[473] For purposes of determining net earnings from self-employment, taxpayers are permitted a deduction from net earnings from self-employment equal to the product of the taxpayer's net earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), *i.e.*, 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual's net earnings are economically the equivalent of an employee's wages plus the employer share of FICA taxes. The deduction is intended to provide parity between FICA and SECA taxes. In addition, self-employed individuals may deduct one-half of self-employment taxes for income tax purposes under section 164(f).

[474] Sec. 1366.

[475] This treatment differs from a partner's distributive share of income or loss from the partnership's trade or business, which is generally subject to SECA tax, as described below. Sec. 1402(a).

compensation and therefore are wages subject to the FICA tax, or rather, are properly characterized as another type of income that is not subject to FICA tax.[476]

In cases addressing whether payments to an S corporation shareholder were wages for services or were corporate distributions, courts have recharacterized a portion of corporate distributions as wages if the shareholder performing services did not include any amount as wages.[477] In cases involving whether reasonable compensation was paid (not exclusively in the S corporation context), courts have applied a multi-factor test to determine reasonable compensation, including such factors as whether the individual's compensation was comparable to compensation paid at comparable firms.[478] The Seventh Circuit, however, has adopted an "independent investor" analysis differing from the multi-factor test in that it asks whether an inactive, independent investor would be willing to compensate the employee as he was compensated.[479] The independent investor test has been examined and partially adopted in some other Circuits, changing the analysis under the multi-factor test.[480]

Partners

In general

A partnership is treated as a passthrough entity for Federal income tax purposes. Each partner includes in income its distributive share of partnership items of income, deduction, gain and loss.[481]

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[476] See the discussion of case law in, *e.g.*, Richard Winchester, *The Gap in the Employment Tax Gap*, 20 Stanford Law and Policy Review 127, 2009; James Parker and Claire Y. Nash, *Anticipate Close Inspection of Closely Held Company Pay Practices - Part I*, 80 Practical Tax Strategies 215, April 2008; *Renewed Focus on S Corp. Officer Compensation*, AICPA Tax Division's S Corporation Taxation Technical Resource Panel, Tax Advisor, May 2004, at 280.

[477] *David E. Watson, P.C., v. U.S.*, 668 F.3d 1008 (8th Cir. 2012), cert. denied, 133 S. Ct. 364 (2012); *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990); see also, *e.g.*, *Joseph M. Grey Public Accountant, P.C., v. U.S.*, 119 T.C. 121 (2002), aff'd, 93 Fed. Appx. 473, 3d Cir., April 7, 2004, and *Nu-Look Design, Inc. v. Commissioner*, 356 F.3d 290 (3d Cir. 2004), cert. denied, 543 U.S. 821 (2004), in which an officer and sole shareholder of an S corporation argued unsuccessfully that he had no wages and that he received payments in his capacity as shareholder or as loans, rather than as wages subject to FICA tax.

[478] See, *e.g.*, *Haffner's Service Stations, Inc. v. Commissioner*, 326 F.3d 1 (1st Cir. 2003).

[479] *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999).

[480] In *Metro Leasing and Dev. Corp. v. Commissioner*, 376 F.3d 1015 (9th Cir. 2004) at 10-11, the Ninth Circuit noted that it is helpful to consider the perspective of an independent investor, and pointed to other Circuits that apply the multi-factor test through the lens of the independent investor test, citing *RAPCO Inc. v. Commissioner*, 85 F.3d 950 (2d Cir. 1996). In determining whether compensation is reasonable, the U.S. Tax Court has applied the multi-factor test viewed through the lens of an independent investor where a case is appealable to a U.S. Court of Appeals which has neither adopted nor rejected the independent investor test. See *Chickie's and Pete's, Inc. v. Commissioner*, T.C. Memo. 2005-243, 90 T.C.M. 399 (2005), at footnote 9; *Miller & Sons Drywall, Inc. v. Commissioner*, T.C. Memo. 2005-114, 89 T.C.M. 1279 (2005).

[481] Secs. 701, 702.

A partner's distributive share of partnership items is not treated as wages for FICA tax purposes. Rather, a partner who is an individual is subject to the SECA tax on his or her distributive share of trade or business income of the partnership. The net earnings from self-employment generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership (excluding specified types of income, such as rent, dividends, interest, and capital gains and losses, as described above[482]). This rule applies to individuals who are general partners.

Limited partners

An exclusion from SECA applies in certain circumstances for limited partners of a partnership.[483] Under this rule, in determining a limited partner's net earnings from self-employment, an exclusion is generally provided for his or her distributive share of partnership income or loss. The exclusion does not apply with respect to guaranteed payments to the limited partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.[484]

The owners of a limited liability company that is classified as a partnership for Federal tax purposes are treated as partners for tax purposes. However, under State law, limited liability company owners are not defined as either general partners or limited partners.

[482] Sec. 1402(a).

[483] Sec. 1402(a)(13).

[484] In *Renkemeyer, Campbell, & Weaver, LLP, v. Commissioner* (136 T. C. 137, 150 (2011)), the Tax Court held that distributive shares of limited partners in a law firm that was an LLP (limited liability partnership under applicable State law) of partnership income "arising from the legal services they performed in their capacity as partners in the law firm are subject to self-employment tax" in the years at issue. See also Amy S. Elliott, "Tax Court Decision Could Reignite Debate Over Partnerships and Employment Taxes," *Tax Notes Today*, March 11, 2011. See also *Howell v. Commissioner* (T.C. Memo. 2012-303, Nov. 1, 2012), in which the Tax Court concluded that a member of a limited liability company (treated as a partnership for tax purposes) who received guaranteed payments had performed services for the partnership and therefore was required to include the payments in net earnings from self-employment. In 1997, the Treasury Department issued proposed regulations defining a limited partner for purposes of the self-employment tax rules. Prop. Treas. Reg. sec. 1.1402(a)-2 (January 13, 1997). These regulations provided, among other things, that an individual is not a limited partner if the individual participates in the partnership business for more than 500 hours during the taxable year. However, in the Taxpayer Relief Act of 1997, the Congress imposed a moratorium on regulations regarding employment taxes of limited partners. The moratorium provided that any regulations relating to the definition of a limited partner for self-employment tax purposes could not be issued or effective before July 1, 1998. No regulations have been issued to date.

Description of Proposal

The proposal changes the SECA tax treatment of the pro rata share of income of S corporation shareholders and the distributive share of income of limited partners, including members of LLCs who might be viewed as limited partners.[485]

Under the proposal, S corporation shareholders and limited partners who materially participate in a professional service business through the entity must take into account their shares of S corporation or partnership income in determining net earnings from self-employment.[486]

S corporation shareholders and limited partners who do not materially participate take into account only that portion of their share of income that represents reasonable compensation for services in the business. Reasonable compensation is defined generally as under present law, but may not be less than any guaranteed payment received for services in the business.

Under the proposal, material participation generally means working for at least 500 hours per year in the professional service business, and includes standards for material participation set forth in regulations under the passive loss rules (present-law Code section 469), not taking into account the section 469 limited partner exception.

For purposes of the proposal, a professional service business means one in which substantially all the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or management, brokerage services, and lobbying.

The proposal retains the present-law exclusions from net earnings from self-employment for rents, dividends, interest, and capital gains and losses of the business, and certain partner retirement income.

Under the proposal, the wages − currently subject to FICA tax via withholding − of an S corporation shareholder are instead included in earnings subject to SECA taxes. Treasury regulatory authority to implement the proposal is provided.

The proposal does not change the SECA tax treatment of sole proprietorships. The proposal does not change the SECA tax treatment of individuals engaged in businesses other than professional service businesses through an S corporation, a partnership, a limited partnership, or an LLC that is treated for tax purposes as a partnership.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2014.

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[485] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), Item XV.D., reprinted in the back of this volume.

[486] The proposal also makes parallel changes to corresponding provisions of the Social Security Act.

Analysis

In general

The proposal seeks to reduce tax-motivated economic distortions created under the self-employment tax by eliminating differences in self-employment tax treatment that are based on historical, now outdated, differences among business entities and among owners of business entities under State law. In this respect, the proposal applies SECA tax to the distributive share of earnings of S corporation shareholders in some circumstances, and expands the circumstances in which SECA tax applies to limited partners in partnerships.

The proposal seeks to reduce administrative difficulties in enforcing the self-employment tax law by reducing the application of the reasonable compensation test, which requires facts and circumstances determinations. Specifically, the proposal excludes from the reasonable compensation factual inquiry that would otherwise apply under current case law, the situation in which an S corporation shareholder materially participates in a professional service business through the entity. For such S corporation shareholders, the proposal applies the present-law SECA rule for general partners (which does not involve a reasonable compensation inquiry and which excludes from SECA tax specified types of capital income such as interest, dividends, rent, and capital gains).

Proponents argue that the favorable self-employment tax treatment of S corporation shareholders and limited partners under present law, compared to the employment and self-employment tax treatment of other business owners and service providers under present law, has led to serious economic distortions.[487] Business arrangements are contorted to yield the best self-employment tax result rather than the best form of doing business. Voluntary compliance with the tax system is soured by the ability of S corporation shareholders and limited partners to escape some or all employment tax, while other business owners' and workers' compensation is subject to the tax.[488] Some attribute the quick growth of S corporations to employment tax avoidance motives, noting that the issue becomes more widespread as time passes.

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[487] In a 2009 report, the Government Accountability Office (GAO) stated, "[u]sing IRS data, GAO calculated that in the 2003 and 2004 tax years, the net [S corporation] shareholder compensation underreporting equaled roughly $23. 6 billion, which could result in billions in annual employment tax underpayments." Government Accountability Office, *Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules,* December 2009 Report to the Committee on Finance, U.S. Senate, GAO-10-195. See also Peter J. Reilly, "S Corporation SE Avoidance Still a Solid Strategy," *Forbes*, August 25, 2013, http://www.forbes.com/sites/peterjreilly/2013/08/25/s-corporation-se-avoidance-still-a-solid-strategy/ .

[488] Treasury Inspector General for Tax Administration, *Actions are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations*, May 2005, Reference No. 2005-30-080, at 2. The report discusses options for addressing the compliance problem, including an option to apply employment tax generally to the operating income of an S corporation in which any one individual (including his or her family members) owns more than 50 percent of the stock. *Id.* at 18-19. A related report describes the Treasury Inspector General for Tax Administration's review to evaluate whether the IRS has an effective strategy to measure employment tax reporting compliance: Treasury Inspector General for Tax Administration, *Additional Work is Needed to Determine the Extent of Employment Tax Underreporting*, August 2005, Reference No. 2005-30-

The proposal eliminates some of the differences in employment tax treatment among S corporation shareholders and limited partners by applying the same standard to them in particular fact situations. That is, any S corporation shareholder or limited partner is subject to self-employment tax on his or her distributive share of the entity's trade or business income if he or she materially participates in the entity's professional service business. If he or she does not materially participate in the entity's professional service business, then the reasonable compensation factual inquiry of present law is made uniformly applicable under the proposal. That is, the portion of an S corporation's distributive share representing reasonable compensation for his or her services from the professional service business is subject to self-employment tax.

Under the proposal, the taxpayer applies a material participation standard and maintains records to support his or her position, rather than the current system of enforcement relying largely on IRS audits and the outcome of litigation. Similarly, the taxpayer would have to determine his or her reasonable compensation based on applicable facts and circumstances or on standards ultimately developed under Treasury regulations. This aspect of the proposal does not completely resolve the administrative difficulties of present law, in which the reasonable compensation raises factual issues. Factual issues of material participation and reasonable compensation could still be the subject of potential disputes under the proposal, unlike under the general partner rule of present law in which material participation and reasonable compensation are irrelevant.

The proposal does not specifically change the present-law rule in some other fact situations. The proposal does not change the present-law employment tax treatment of S corporation shareholders and limited partners if the entities are not engaged in professional service businesses. The disparity in treatment of S corporation shareholders and other business owners remains under the proposal for these other businesses. It could be said that these other businesses may be less prevalent in S corporation form, so this difference is not very significant, although others might assert this is not accurate. [489]

Though the proposal eliminates some disparities in employment tax treatment, other disparities are either retained as-is, or are modified but still give rise to disparate treatment. For example, the proposal does not specify that it changes the present-law employment tax treatment of general partners in partnerships engaged either in professional service businesses, or in other businesses, though the proposal does change the tax treatment of limited partners. Thus, under the proposal, in a limited partnership with both general and limited partners that is engaged in a professional service business, different SECA tax treatment still applies to partners within the same partnership. General partners include their distributive shares in net earnings from self-

126. See also, *Renewed Focus on S Corp. Officer Compensation*, AICPA Tax Division's S Corporation Taxation Technical Resource Panel, Tax Advisor, May 2004, p. 280.

[489] Recent data suggest that about a third of returns of S corporations and between a quarter and a third of S corporation net income come from service businesses that could be considered professional service businesses. Internal Revenue Service, *IRS Statistics of Income Corporation Source Book*, Publication 1053 (Rev. 3-2014), http://www.irs.gov/uac/SOI-Tax-Stats-Corporation-Source-Book:-U.S.-Total-and-Sectors-Listing, and JCT staff calculations based on industry sector codes.

employment regardless of their material participation. Limited partners who materially participate include their distributive shares in net earnings from self-employment. Limited partners who do not materially participate include a portion of their distributive share equal to reasonable compensation for services in net earnings from self-employment. Further, outside the context of the professional service business, the proposal does not eliminate the disparate treatment under present law of S corporation shareholders, limited partners, and general partners.

The proposal could, consequently, be criticized as inadequate to address the problem of disparate application of self-employment tax. Critics might argue that, to fully eliminate disparate treatment, all S corporation shareholders, limited partners, and general partners should be subject to self-employment tax in the same manner, without regard to whether the entity is engaged in a professional service business. In pursuing uniformity of treatment, one option would be to apply the proposal's material participation test and reasonable compensation analysis to all business owners other than C corporation owners; another could be to apply the present-law rule for general partners and sole proprietors to all business owners other than C corporation owners.

Criticisms could be made of either of these approaches. Under the first approach, both the material participation test and any reasonable compensation analysis are dependent on the facts of each situation. Such rules are applied on a case-by-case basis and are not self-executing, bright-line standards. Substituting the material participation and reasonable compensation inquiries for the relatively simple mechanical rule that applies to general partners and sole proprietors under present law worsens rather than improves the administrability of the self-employment tax. This would be contrary to one of the goals of the proposal to reduce enforcement challenges in the self-employment tax. In addition, it would create disparate treatment where none exists today. That is, the application of the SECA tax would depend on material participation, a distinction not made today for general partners or sole proprietors.

The second approach of extending the present-law rule for general partners and sole proprietors to limited partners and S corporation shareholders may not raise either an administrability concern or result in a disparity among business owners. However, some might oppose it on the theory that self-employment tax should apply, conceptually, to labor income and not to capital income. It has been argued that an inquiry into the individual's material participation in a business and limiting the net earnings from self-employment to reasonable compensation is consistent with the notion that self-employment tax should apply to labor income. Historically, the employment tax has applied to labor income, relating very roughly to the rules for accruing benefits under the Social Security system, which requires the individual to perform quarters of labor.[490] But it could be asserted that the present-law calculation of the net earnings from self-employment already excludes capital income from partnerships in the case of general partners, in that the self-employment tax does not apply to specified capital income items, namely rentals from real estate in certain circumstances, dividends and interest, and gains

[490] See Patricia E. Dilley, *Breaking the Glass Slipper - Reflections on the Self-Employment Tax*, 54 Tax Law. 65 (Fall 2000) at note 18. Benefit accruals have historically been tied to performance of labor (quarters of service), but the amount of FICA taxes collected does not necessarily relate to the individual's Social Security benefits.

or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers.

Given the competing considerations in leveling the application of self-employment tax, advocates of the proposal may argue, the proposal represents a reasonable first step towards eliminating the distortions created under present law. Under the proposal, the relatively favorable treatment of S corporation shareholders and limited partners would be reduced, with the result that choice of business entity would be somewhat less tax-motivated in more situations than it is under present law. Further, it is argued, because of the breadth and seriousness of the problem under present law, a proposal that starts to address the issue and that can be administered is needed, whether it is a complete solution or not.

The stated purposes of the proposal also include the purpose to address the issue of a gap in application of net investment income tax for S corporation shareholders. That is, S corporation shareholders are not only not subject to self-employment tax (except to the extent reasonable compensation exceeds their wages), but also, active S corporation shareholders are generally not subject to the net investment income tax[491] to which owners of other passthrough entities are generally subject. It could be argued that the nonapplication of both of these taxes exacerbates a tax-motivated entity choice favoring S corporations over other forms of doing business. Applying the self-employment tax to S corporation shareholders to a greater degree than under present law could mitigate this policy concern, it is argued. On the other hand, the net investment income tax is a separate tax rule and is not related to lumpy application of the employment and self-employment tax rules across different forms of business ownership. If reducing tax disparities among business forms is a goal, then a more direct solution might be to reduce the number of different sets of tax rules for businesses, such as by providing for a single type of passthrough entity regime for Federal tax purposes. However, such a proposal is beyond the scope of the employment and self-employment tax rules to which the proposal is addressed.

Technical concerns

A technical issue relating to the proposal has to do with non-materially-participating family members (or other related persons) of a service provider in a professional service business. In the absence of a rule addressing the treatment of family members' (or related persons') distributive shares of S corporation income, the material participation standard could potentially be avoided. For example, the material participation threshold could be circumvented using arrangements in which the service provider owns one percent of the stock of an S corporation, and nonservice providing family members own 99 percent. This concern could be addressed, for example, through a statutory rule or regulation providing that a shareholder's pro rata share of S corporation income or loss described in section 1366 that is attributable to the professional service business includes the pro rata share of each member of that shareholder's family of such items of income or loss of the S corporation.

[491] Sec. 1411.

Another technical issue involves tiered entities, for which the proposal does not explicitly provide a rule. For example, the proposal does not specifically address whether a partnership or S corporation should be considered as engaged in a professional service business if it, or a lower-tier entity, is engaged in a professional service business. For example, if a medical professional service business is conducted in a lower-tier partnership in which an S corporation has an interest through tiers of partnerships, the proposal does not address whether the result would be the same as if the individual taxpayer has a direct interest in the partnership's medical professional service business. Similarly, the proposal does not address the use of wholly or partially commonly owned entities to attempt to separate the provision of services (or material participation in the professional service business) from the distributive share of income. Statutory or regulatory rules addressing tiered and commonly-owned entities could be developed if needed to address these concerns.

Some might question why the proposal provides that the FICA wages of S corporation shareholder-employees are converted to SECA net earnings from self-employment under the proposal. Arguably, this approach worsens compliance, as it is demonstrable that withholding (as under FICA) improves compliance compared to nonwithholding collection mechanisms (as under SECA), and further, new lines drawn by the proposal for SECA purposes could introduce new forms of noncompliance. Another possible approach might be to credit FICA tax paid with respect to an S corporation shareholder employee against that individual's SECA tax liability under the proposal.

PART XVI – OTHER REVENUE RAISERS

A. Increase Oil Spill Liability Trust Fund Financing Rate by One Cent and Update the Law to Include Other Sources of Crudes

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 506-507. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVI.C, reprinted in the back of this volume.

B. Reinstate Superfund Taxes

1. Reinstate and extend superfund excise taxes

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 508-510. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVI.D.1, reprinted in the back of this volume.

2. Reinstate superfund environmental income tax

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 508-510. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVI.D.2, reprinted in the back of this volume.

C. Increase Tobacco Taxes and Index for Inflation

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 118-120. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVI.E, reprinted in the back of this volume.

D. Make Unemployment Insurance Surtax Permanent

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 511-512. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVI.F, reprinted in the back of this volume.

E. Provide Short-Term Tax Relief to Employers and Expand Federal Unemployment Tax Act (FUTA) Base

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 513-515. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVI.G, reprinted in the back of this volume.

F. Enhance and Modify the Conservation Easement Deduction

1. Enhance and make permanent incentives for the donation of easements

Present Law†

Charitable contributions generally

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.[492]

In general, in any taxable year, charitable contributions by a corporation are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's taxable income computed without regard to net operating or capital loss carrybacks. Total deductible contributions by an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations generally may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base, (2) contributions

[492] Secs. 170, 2055, and 2522, respectively.

of cash to most private nonoperating foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions in excess of the applicable percentage limits generally may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

Capital gain property

Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property to a qualified charity are deductible at fair market value within certain limitations. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(A) (*e.g.*, public charities, private foundations other than private non-operating foundations, and certain governmental units) generally are deductible up to 30 percent of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions of capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(B) (*e.g.*, private non-operating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

For purposes of determining whether a taxpayer's aggregate charitable contributions in a taxable year exceed the applicable percentage limitation, contributions of capital gain property are taken into account after other charitable contributions.

Qualified conservation contributions

Qualified conservation contributions are an exception to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property.[493] A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property. Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental

[493] Secs. 170(f)(3)(B)(iii) and 170(h).

conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Qualified conservation contributions of capital gain property are subject to the same limitations and carryover rules as other charitable contributions of capital gain property.

Temporary rules regarding contributions of capital gain real property for conservation purposes

In general

Under a temporary provision[494] the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions (as defined under present law), generally, conservation easements. Instead, individuals may deduct the fair market value of any qualified conservation contribution to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions.

Individuals are allowed to carry over any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years.

For example, assume an individual with a contribution base of $100 makes a qualified conservation contribution of property with a fair market value of $80 and makes other charitable contributions subject to the 50-percent limitation of $60. The individual is allowed a deduction of $50 in the current taxable year for the non-conservation contributions (50 percent of the $100 contribution base) and is allowed to carry over the excess $10 for up to 5 years. No current deduction is allowed for the qualified conservation contribution, but the entire $80 qualified conservation contribution may be carried forward for up to 15 years.

Farmers and ranchers

In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

In the above example, if the individual is a qualified farmer or rancher, in addition to the $50 deduction for non-conservation contributions, an additional $50 for the qualified conservation contribution is allowed and $30 may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified

[494] Sec. 170(b)(1)(E).

conservation contribution is allowable up to 100 percent of the excess of the corporation's taxable income (as computed under section 170(b)(2)) over the amount of all other allowable charitable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.[495]

As an additional condition of eligibility for the 100 percent limitation, with respect to any contribution of property in agriculture or livestock production, or that is available for such production, by a qualified farmer or rancher, the qualified real property interest must include a restriction that the property remain generally available for such production. (There is no requirement as to any specific use in agriculture or farming, or necessarily that the property be used for such purposes, merely that the property remain available for such purposes.)

A qualified farmer or rancher means a taxpayer whose gross income from the trade or business of farming (within the meaning of section 2032A(e)(5)) is greater than 50 percent of the taxpayer's gross income for the taxable year.

Termination

The temporary rules regarding contributions of conservation easements do not apply to contributions made in taxable years beginning after December 31, 2013.[496]

Description of Proposal

The proposal would reinstate and make permanent the enhanced incentives for easement contributions that expired at the end of 2013.[497]

Effective date.−The proposal is effective for contributions made on or after January 1, 2014.

Analysis

Encouraging conservation

The proposal is designed to encourage conservation by enhancing the tax deduction for contributions of conservation easements. When a land owner donates a conservation easement to a charitable organization, he or she places legal restrictions on the development and use of the land. These restrictions reduce the fair market value of the land (*i.e.*, the amount a willing buyer would pay and a willing seller would accept for the property, neither being compelled to enter

[495] Sec. 170(b)(2)(B).

[496] Secs. 170(b)(1)(E)(vi) and 170(b)(2)(B)(iii).

[497] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVI.H.1, reprinted in the back of this volume.

into the transaction). The reduction in fair market value generally is the measure of the donation to charity.

The amount a taxpayer may deduct for a charitable donation is limited to a percentage of his or her contribution base (*i.e.*, his or her AGI, disregarding any net operating loss carryback). For contributions of capital gain property (such as land or an easement on land) to a public charity, the deductible value is limited to 30% of the taxpayer's contribution base.

Some taxpayers may own land with substantial value, yet have relatively modest annual income. If such a taxpayer donates an easement that substantially reduces the value of a parcel of land, the percentage limit on charitable contributions may restrict the amount of the taxpayer's deduction in the year of the contribution and in the five subsequent years to which excess contributions may be carried. As a result, the present law rules may in some instances reduce a landowner's incentive to retain the property and donate an historic or conservation easement, rather than developing or selling his or her land. The proposal addresses this concern by increasing the applicable percentage limit and extending the carryforward period for easement contributions, with the ultimate goal of encouraging conservation and historic preservation.

Valuation and compliance concerns

The proposal increases the tax incentives for donating easements, which historically have raised significant valuation and compliance concerns.[498]

Contributions of property

The determination of fair market value creates a significant opportunity for error or abuse by taxpayers making charitable contributions of property. To the extent that taxpayers claim inflated valuations that are not corrected by the IRS, the Treasury loses revenue that should be collected under present law because charitable contribution deductions are greater than are warranted. Whether due to mistake, incompetence, misunderstanding of the law or facts, or efforts to evade taxes, valuation misstatements are common.

In addition, valuation is a difficult and resource intensive issue for the IRS to identify, audit, and litigate. The IRS must determine which values are suspect, prepare its own appraisal of the questioned property, and persuade a court that the IRS's value, and not the taxpayer's, is correct. Such hurdles may mean, as a practical matter, that attacking valuation misstatements in the charitable contribution context is not a high priority for the IRS because the probable revenue collected does not compare favorably with the resource cost (at least when compared to other tax compliance areas).

[498] For a more detailed discussion of the valuation and compliance concerns raised by easement contributions, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 565-573 (discussing a proposal to eliminate the charitable deduction for contributions of conservation easements on golf courses); and Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 121-127 (discussing a proposal to restrict deductions and harmonize rules for contributions of conservation easements for historic purposes).

Contributions of easements

Qualified conservation contributions present particularly serious policy and compliance issues. Valuation of easements is especially problematic because the measure of the fair market value of the easement (generally, the difference in fair market value before and after placing the restriction on the property) is highly speculative, considering that, in general, there is no market and thus no comparable sales data for such easements.

The ability of a donor of a qualified conservation contribution to use the retained property after the contribution of the partial interest also makes it difficult to determine whether a significant public benefit or conservation purpose is served by the contribution. For example, if a donor is able to continue to use real property as a residence after the contribution is made, the donor may benefit economically and in other ways from making the contribution, and the extent of the public benefit and conservation purpose may be diminished by such use.

Easement contributions are complex, often taking months or years to plan and effect. To understand fully the economics of such a transaction, taxpayers must be able to determine the tax consequences of the transaction. Extending the easement donation incentives only on a temporary basis makes this determination difficult and, as a result, could cause some land owners who otherwise would make easement contributions to refrain from doing so, thereby reducing the amount of conservation and historic preservation. The proposal addresses this concern by making permanent the enhanced incentives for easement contributions.

2. Eliminate the deduction for contributions of conservation easements on golf courses

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 565-573. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVI.H.2, reprinted in the back of this volume.

3. Restrict deductions and harmonize the rules for contributions of conservation easements for historic preservation

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 121-127. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVI.H.3, reprinted in the back of this volume.

G. Eliminate Deduction for Dividends on Stock of Publicly-Traded Corporations Held in Employee Stock Ownership Plans

Description of Modification

The fiscal year 2015 budget proposal modifies the fiscal year 2014 budget proposal so that the deduction for C corporation dividends paid with respect to employer stock held by an ESOP is repealed in the case of an ESOP sponsored by a publicly-traded C corporation.[499] The fiscal year 2014 budget proposal provided generally for repeal of the deduction for C corporation dividends paid with respect to employer stock held by an ESOP, with an exception for C corporations with annual receipts of $5 million or less.

[499] The fiscal year 2014 budget proposal is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 53-58. The estimated budgetary effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVI.I, reprinted in the back of this volume.

PART XVII − REDUCE THE TAX GAP AND MAKE REFORMS

A. Expand Information Reporting

1. Require information reporting for private separate accounts of life insurance companies

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 574-576. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.A.1, reprinted in the back of this volume.

2. Require a certified taxpayer identification number (TIN) from contractors and allow certain withholding

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 576-579. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.A.2, reprinted in the back of this volume.

3. Modify reporting of tuition expenses and scholarships on Form 1098-T

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 155-156. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.A.3, reprinted in the back of this volume.

4. Provide for reciprocal reporting of information in connection with the implementation of the Foreign Account Tax Compliance Act (FATCA)

Present Law

In general

Persons making payments of certain types of U.S.-source income to non-resident alien individuals are subject to reporting requirements. In general, any amount paid to a foreign payee that is subject to withholding tax is required to be reported annually.[500] An amount subject to

[500] Treas. Reg. sec. 1.1461-1(c)(2)(i).

reporting includes any amount subject to withholding even if no amount is withheld because of a treaty or an exception to taxation. Any amount paid to a foreign payee on which tax was withheld is also subject to reporting.

Amounts subject to reporting include U.S.-source interest, rents, royalties, compensation for services performed in the United States, annuities, pension distributions, corporate distributions, gambling winnings, amounts effectively connected with the conduct of a U.S. trade or business, and scholarship, fellowship, or grant income.[501] There are certain exceptions to the general reporting rule. These exceptions include deposit interest that is not effectively connected with the conduct of a U.S. trade or business, interest or original issue discount on certain short-term obligations, corporate distributions that are neither dividends nor return of basis (described in section 301(c)(3), and items required to be reported on Form W-2.[502]

Exchange of Information

Tax treaties establish the scope of information that can be exchanged between treaty parties. Exchange of information provisions first appeared in the late 1930s,[503] and are now included in all double tax conventions to which the United States is a party. A broad international consensus has coalesced around the issue of bank transparency for tax purposes and strengthened in recent years, in part due to highly publicized tax evasion cases, and the spotlight that the global financial crisis has put on international tax evasion and the need for preventative measures generally. Exchange of information articles in U.S. tax treaties are generally in accord with the United States Model Income Tax Convention of November 15, 2006 (the "U.S. Model treaty") and its predecessors.[504] The U.S. Model treaty in turn conforms to the norms for transparency and effective exchange of information articulated by the OECD. Those standards require the existence of mechanisms for exchange of information upon request; the availability of exchange of information for purposes of both criminal and civil tax matters; absence of restrictions on information exchange caused by application of the dual criminality principle[505] or a domestic tax interest requirement; respect for safeguards and limitations; strict confidentiality rules for information exchanged; and availability of reliable information (in particular bank, ownership, identity, and accounting information) and powers to obtain and provide such

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[501] *Ibid.*

[502] Treas. Reg. sec. 1.1461-1(c)(2)(ii).

[503] Article XV of the U.S.-Sweden Double Tax Convention, signed on March 23, 1939.

[504] For a comparison of the U.S. Model treaty with its 1996 predecessor, *see* Joint Committee on Taxation, *Comparison of the United States Model Income Tax Convention of September 20, 1996 with the United States Model Income Tax Convention of November 15, 2006* (JCX-27-07), May 8, 2007.

[505] The principle of dual criminality derives from the law regarding extradition and grounds for refusal to grant a request. Extradition is generally permitted only if the crime for which a person is to be extradited is treated as a similarly serious offense in the state in which the fugitive has sought refuge. *Restatement (Third) of the Foreign Relations Law of the United States*, sec. 476 (1987). The principle is relevant to a request for exchange of tax information only if the treaty in question limits the scope of its permitted exchanges to criminal tax matters.

information in response to a specific request.[506] The relevant articles of the U.S. and OECD model treaties generally allow the competent authorities of the two treaty jurisdictions to exchange information in any of three ways that treaty countries have traditionally operated[507] – automatic,[508] spontaneous,[509] or specific exchanges.[510]

Interest on bank deposits

A person making a payment of interest aggregating $10 or more to an individual is generally required to file an annual report of the interest paid.[511] Non-resident alien individuals are exempt from U.S. withholding tax on the receipt of interest income from amounts deposited with certain domestic financial institutions ("deposit interest"), if the interest is not effectively connected with the conduct of a U.S. trade or business.[512]

Under regulations finalized in 2012, a financial institution must report interest if the recipient is a nonresident alien who resides in a country with which the United States has a satisfactory exchange of information program under a bilateral agreement and the deposit is maintained at an office in the United States.[513] The IRS has published a list of the 78 countries whose residents are subject to the reporting requirements, and a list of countries with respect to

[506] OECD, *Tax Cooperation: Towards a Level Playing Field, 2008 Assessment by the Global Forum on Taxation*, p. 8.

[507] OECD, Commentary on the Model Treaty Article 26, par. 9 as revised in OECD, *Update to Article 26 of the OECD Model Tax Convention and Its Commentary,* (July 12, 2012), available at http://www.oecd.org/ctp/exchange-of-tax-information/120718_Article%2026-ENG_no%20cover%20%282%29.pdf.

[508] In an automatic exchange of information, the treaty countries identify categories of information that are consistently relevant to the tax administration of the receiving treaty country and agree to share such information on an ongoing basis, without the need for a specific request. Information that is automatically shared under this authority may include information that is not taxpayer-specific as well as items such as news about changes in domestic tax legislation.

[509] A "spontaneous exchange of information" occurs when one treaty country that is in possession of an item of information that it determines may interest the other treaty country for purposes of its tax administration spontaneously transmits the information to its treaty country through their respective competent authorities.

[510] A "specific exchange" is a formal request by one contracting state for information that is relevant to an ongoing investigation of a particular tax matter. These cases are generally taxpayer specific. Those familiar with the case prepare a request that explains the background of the tax case and the need for the information and submit it to the Competent Authority in their country. If he determines that it is an appropriate use of the treaty authority, he forwards it to his counterpart.

[511] Sec. 6049.

[512] Sec. 871(i)(2).

[513] Treas. Reg. secs. 1.6049-4(b)(5) and 1.6049-8.

which the reported information will be automatically exchanged naming only one country, Canada.[514]

FATCA

A reporting and withholding regime for outbound payments,[515] commonly referred to as the Foreign Account Tax Compliance Act ("FATCA"),[516] imposes a withholding tax of 30 percent of the gross amount of certain payments to foreign financial institutions ("FFIs") unless the FFI establishes that it is compliant with the information reporting requirements of FATCA which include identifying certain U.S. accounts held in the FFI. An FFI must report with respect to a U.S. account (1) the name, address, and taxpayer identification number of each U.S. person holding an account or a foreign entity with one or more substantial U.S. owners holding an account; (2) the account number; (3) the account balance or value; and (4) except as provided by the Secretary, the gross receipts, including from dividends and interest, and gross withdrawals or payments from the account.[517]

To facilitate the implementation of FATCA and address any legal impediments that FFIs that are resident in another jurisdiction may otherwise have faced in complying with the terms of FATCA, such as the inability to satisfy information exchange requirements due to privacy laws, in 2012, the United States began negotiations on a series of bilateral intergovernmental agreements ("IGAs"). There are two types of IGAs. The Model 1 IGA is a bilateral agreement with another jurisdiction which allows FFIs to report information about U.S. accounts directly to their local tax authority, followed by the automatic exchange of information on a government-to-government basis with the United States. The Model 1 agreements may be reciprocal or nonreciprocal, meaning the United States may or may not be required to share information it has collected related to U.S. accounts of foreign individuals with the other jurisdiction. The second type of IGA is a Model 2 IGA which requires the FFI to report specified information directly to the IRS and may be supplemented by a government-to-government exchange of information on request. The United States has 42 signed Model 1 IGAs and six signed Model 2 IGAs. In addition to the signed agreements, the United States has listed 46 additional Model 1 IGAs and

[514] Rev. Proc. 2012-24, I.R. B. 2012-20 (May 14, 2012), available at http://www.irs.gov/irb/2012-20_IRB/ar11.html.

[515] Hiring Incentives to Restore Employment Act of 2010, Pub. L. No. 111-147.

[516] Foreign Account Tax Compliance Act of 2009 is the name of the House and Senate bills in which the provisions first appeared. See H.R. 3933 and S. 1934 (October 27, 2009).

[517] Sec. 1471(c). Although the information reporting requirements under Chapter 4 were initially to go into effect with respect to payments made after December 31, 2012, the IRS and Treasury issued regulations providing for a phased implementation beginning on January 1, 2014 and continuing through 2017. Under the regulations, persons with withholding responsibility were required to begin withholding with respect to withholdable payments made after December 31, 2013. See 78 Fed. Reg. 5874 .June 30, 2014. The withholding requirement was further delayed and is now applicable to payments made after June 30, 2014. Treas. Reg. 1.1471-2T(a).

seven Model 2 IGAs for jurisdictions that reached agreements in substance and consented to be listed by the United States.[518]

Description of Proposal

The proposal requires certain financial institutions to report the account balance (including, in the case of a cash value insurance contract or annuity contract, the cash value or surrender value) for all financial accounts maintained at a U.S. office and held by foreign persons.[519] The proposal also would expand the current reporting required with respect to U.S.-source income paid to accounts held by foreign persons to include similar non-U.S. source payments. Finally, the Secretary would be granted authority to issue Treasury regulations to require financial institutions to report the gross proceeds from the sale or redemption of property held in, or with respect to, a financial account, information with respect to financial accounts held by certain passive entities with substantial foreign owners, and such other information that the Secretary or his delegate determines is necessary to carry out the purposes of the proposal.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2015.

Analysis

The United States has come under increasing pressure to eliminate policies that provide foreign persons with the ability to shelter income in U.S. financial institutions. The criticism has focused on disparities between the U.S. standards and foreign standards governing the level of due diligence required in establishing customer identification (often colloquially referred to as "know-your-customer" rules) for financial institutions, in particular, with regard to the maintenance of information on beneficial ownership. With respect to the latter, U.S. norms have been criticized in recent years.[520] Because the information obtained through information exchange relationships with other jurisdictions has been central to recent successful IRS enforcement efforts against offshore tax evasion, the Treasury argues that the United States should foster information exchange relationships through cooperation and reciprocity. According to the Treasury, a jurisdiction's willingness to share information with the United States often depends on the United States' willingness and ability to reciprocate by exchanging comparable

[518] For the most recent list of applicable IGAs, see Department of the Treasury Resource Center FATCA - Archive, available at http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA-Archive.aspx.

[519] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), Item XVII.A.4, reprinted in the back of this volume.

[520] Financial Action Task Force, IMF, *Summary of the Third Mutual Evaluation Report on Anti-Money Laundering and Combating the Financing of Terrorism United States of America,* pp. 10-11 (June 23, 2006); Government Accountability Office, *Company Formations: Minimal Ownership Information Is Collected and Available,* a report to the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate GAO-06-376 (April 2006); Government Accountability Office*, Suspicious Banking Activities: Possible Money Laundering by US Corporations Formed for Russian Entities*, GAO-01-120 (October 31, 2006).

information. Thus, the Treasury believes that United States should expand reporting requirements for financial institutions in the United States to report the same comprehensive information required under FATCA with respect to accounts held for foreign persons, or by certain passive entities with substantial foreign owners. The Administration argues that the collection of this information will facilitate the intergovernmental cooperation contemplated by the IGAs, encourage other jurisdiction's participation in information exchange relationships, and promote continued, successful IRS enforcement efforts against offshore tax evasion.

The Treasury believes that the ability to exchange information reciprocally is particularly important in connection with the implementation of FATCA. Foreign law may prevent certain foreign financial institutions from complying with the FATCA reporting provisions. Such legal impediments can be addressed through intergovernmental agreements under which the foreign government agrees to provide the information required by FATCA to the IRS. By requiring financial institutions in the United States to report to the IRS the comprehensive information required under FATCA with respect to accounts held by certain foreign persons, or by certain passive entities with substantial foreign owners, the Treasury intends to facilitate the intergovernmental cooperation contemplated by intergovernmental agreements by enabling the IRS to reciprocate with information that is equivalent to levels of information available from cooperative foreign governments in appropriate circumstances to support the efforts of those governments to address tax evasion by their residents.

In contrast, several commentators oppose the implementation of FATCA and the collection and sharing of information that, they argue, violate the privacy of U.S. citizens. Regardless of the tax-enforcement utility of these provisions, these commentators argue that such information exchange requirements, including FATCA, violate important privacy protections, disregard the sovereign laws of other nations, and will cost the U.S. economy substantial sums in compliance costs.

Some commentators have pointed out that information exchange requirements, as executed through FATCA, may have distorting effects on worldwide markets.[521] Some critics argue that compliance costs imposed by information exchange requirements could lead to distorted preferences in the worldwide market by discouraging financial institutions from serving particular clients, discouraging investment in particular nations, and discouraging citizenship or residency in certain nations.[522] Other critics argue that information reporting and reciprocal information exchange requirements under FATCA, and in accord with the IGAs do little to achieve the goal of information symmetry as such requirements will only encourage asset relocation to an increasingly limited group of non-cooperating jurisdictions, thereby only

[521] James Hamilton, "FATCA Gaining Global Acceptance in Combating Tax Evasion," *CCH Special Report*, September 2013, Allison Christians, "Putting the Reign Back in Sovereign," 40 *Pepperdine Law Review* 1373, 2013.

[522] Frederic Behrens, "Using A Sledgehammer to Crack A Nut: Why FATCA Will Not Stand," 2013 *Wisconsin Law Review* 205, p. 236 (2013).

creating added benefits of increased tax revenue from relocated assets for such non-cooperating jurisdictions.[523]

The Treasury is not alone in seeking to curb tax avoidance through exchange of tax information; in fact, the OECD released its Standard for Automatic Exchange of Financial Account Information in Tax matters (the "common reporting standard") which was approved in September, 2014 by the G20 Finance Ministers.[524] The common reporting standard has provisions similar to the FATCA provisions. It requires annual reporting by financial institutions on financial accounts. Required information includes the names, residence country, and tax identification number of the account holder, account balances, income, and gross receipts on the account. The common reporting standard defines financial institutions and financial accounts consistently with the definitions in the IGAs. More than 65 jurisdictions have publicly committed to implementing the common reporting standard, with more than 40 committing to be early adopters of automatic information exchange in 2017.[525]

5. Provide authority to readily share beneficial ownership information of U.S. companies with law enforcement

Present Law

Entity formation in the United States is generally governed by the State law. The States determine the types of entities that may be formed, the requirements for formation, the information that is required to be filed with the State upon formation and any subsequent information that may be required by the State. States may impose requirements for disclosing beneficial ownership of entities, but there is not currently a Federal standard requiring legal entities to report beneficial ownership of a legal entity at the time the entity is formed.

There are Federal requirements for providing certain information about the beneficial owners or responsible parties of certain legal entities under Titles 26 (the Internal Revenue Code) and 31 (Money and Finance). These requirements are discussed briefly below. Additionally, the present law confidentiality and disclosure rules under Title 26 are discussed.

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[523] Marc D. Shepsman, *Buying FATCA Compliance: Overcoming Holdout Incentives to Prevent International Tax Arbitrage*, 36 Fordham Int'l L.J. 1767, 1811 (2013).

[524] OECD, *Standard for Automatic Exchange of Financial Information in Tax Matters*, July 21, 2014, available at http://www.oecd.org/ctp/exchange-of-tax-information/standard-for-automatic-exchange-of-financial-information-in-tax-matters.htm.

[525] OECD Automatic Exchange of Information, available at http://www.oecd.org/tax/exhange-of-tax-information/automaticexchange.htm.

Title 26 - responsible party

A person required to make certain returns or statements is required to furnish a taxpayer identifying number as prescribed by the Secretary.[526] For individuals, the identifying number used for filing an individual tax return is generally the individual's social security account number.[527] Certain individuals and entities are required to apply for an employer identification number ("EIN") [528] including, among others, individuals and entities with employees, or who are required to file employment or excise tax returns or withhold tax on income. Corporations or partnerships that operate a business in the United States and trusts, estates, or certain other entities are also required to apply for an EIN. The Secretary has authority to require information as necessary to assign an identifying number to any person.[529]

The information required to apply for an EIN includes the legal name of the entity or individual for whom the EIN is requested, any trade name or "doing business as" name used, the mailing address and street address, the county and State of the principal place of business, the name and TIN of the responsible party, the type of entity, the date the business was started or acquired, and the closing month of the accounting year.

EIN applicants must disclose the name and TIN of the "true principal officer, general partner, grantor, owner or trustor."[530] The IRS refers to this person as the "responsible party," *e.g.*, the person or entity which "controls, manages, or directs the applicant entity and the disposition of its funds and assets."[531] For entities with shares or interest traded on a public exchange, or which are registered with the Securities and Exchange Commission, the responsible party is (1) the principal officer, if the business is a corporation, (2) a general partner, if a partnership, (3) the owner of an entity that is disregarded as separate from its owner, or (4) a grantor, owner, or trustor, if a trust. For all other entities, the responsible party is the person who has a level of control over, or entitlement to, the funds or assets in the entity that, as a practical matter, enables the individual, directly or indirectly, to control, manage, or direct the entity and the disposition of its funds and assets. Where there is more than one responsible party with

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[526] The Secretary requires use of a taxpayer identifying number. See Secs. 6109(a) and Treas. Reg. Sec. 301.6109-1. The term taxpayer identifying number is used interchangeably in the Code, regulations and instructions with "TIN," a term defined in section 7701(a)(41) as the identifying number assigned to a person under section 6109.

[527] Sec. 6109(a).

[528] To apply for an EIN, a person is required to file Form SS-4, either on-line, via telephone, or by filing a Form SS-4 with the IRS. See Form SS-4 instructions, available at http://www.irs.gov/pub/irs-pdf/iss4.pdf.

[529] 6109(c).

[530] Internal Revenue Service Website, *Small Business & Self Employed,* "Responsible Parties and Nominees," available at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Responsible-Parties-and-Nominees. Where there is a nominee, the true responsible party is the principal officer, general partner, etc., not the nominee.

[531] *Ibid.*

respect to an entity, the entity may list the party the entity wants the IRS to recognize as the responsible party.

Title 31 - beneficial ownership

The regulations implementing Title 31 require certain financial institutions[532] to comply with anti-money laundering and counter-terrorist financing rules ("AML/CTF rules"),[533] including requiring financial institutions to develop and maintain a written customer identification program as part of its anti-money laundering policies and procedures. Additionally, financial institutions must perform customer due diligence. The due diligence requirements are enhanced where the account or the financial institution has a higher risk profile.[534]

A customer identification program at a minimum requires the financial institution to collect the name, date of birth (for individuals), address,[535] and identification number[536] for new customers. In fulfilling AML/CTF obligations, financial institutions are required to verify enough customer information to enable the financial institution to form a "reasonable belief that it knows the true identity of each customer."[537] In most cases the AML/CTF rules do not require financial institutions to look through an entity to determine its ultimate ownership.[538] However, based on the financial institution's risk assessment, the financial institution may need to obtain

[532] The term financial institution is broadly defined under 31 U.S.C. sec. 5312(a)(2) or (c)(1) and includes U.S. banks and agencies or branches of foreign banks doing business in the United States, insurance companies, credit unions, brokers and dealers in securities or commodities, money services businesses, and certain casinos.

[533] The U.S. AML/CTF rules, sometimes colloquially referred to as know-your-customer rules, are issued pursuant to the Bank Secrecy Act of 1970, as amended by Title III, The International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 of the USA PATRIOT Act. The Bank Secrecy Act is codified at 12 U.S.C. 1829b, 12 U.S.C. 1951-1959, 18 U.S.C. 1956, 1957, and 1960, and 31 U.S.C. 5311-5314 and 5316-5332 and notes thereto, with implementing regulations at 31 CFR chapter X.

[534] Relevant risks include the types of accounts held at the financial institution, the methods available for opening accounts, the types of customer identification information available, and the size, location, and customer base of the financial institution. 31 C.F.R. sec. 1020.220(a)(2).

[535] For a person other than an individual the address is the principal place of business, local office, or other physical location. 31 C.F.R. sec. 10200.220(a)(2)(i)(3)(iii).

[536] For a U.S. person the identification number is the TIN. For a non-U.S. person the identification number could be a TIN, passport number, alien identification number, or number and country of issuance of any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard. 31 C.F.R. sec. 1020.220(a)(2)(i)(4).

[537] See 31 C.F.R. sec. 1020.220(a)(2).

[538] For example, a financial institution is not "required to look through trust, escrow, or similar accounts to verify the identities of beneficiaries and instead will only be required to verify the identity of the named accountholder." See 68 Fed. Reg. 25,090, 25,094 (May 9, 2003).

information about individuals with authority or control over such an account in order to verify the identity of the customer.[539]

Enhanced due diligence is required if customers are deemed to be of higher risk, and is mandated for certain types of accounts including foreign correspondent accounts, private banking accounts, and accounts for politically exposed persons. Private banking accounts are considered to be of significant risk and enhanced due diligence requirements imposed by section 312 of the USA PATRIOT Act include identification of nominal and beneficial owners for these accounts, as well as ascertaining the source of deposited funds, review of account activity, and determination of whether the beneficial owner is a politically exposed person, in which case "enhanced scrutiny" is required for the purpose of determining whether transactions may include the proceeds of foreign corruption.[540]

On July 30, 2014, the U.S. Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN") issued a notice of proposed rulemaking[541] strengthening the customer identification procedures required of banks and certain other financial institutions. The proposed rule requires the banks and institutions to identify the natural persons who are beneficial owners of the legal-entity customers of such institutions. The notice includes explicit requirements for verifying the identity of an entity's beneficial owners, subject to certain exemptions. The beneficial owners are defined to include each individual who, directly or indirectly, owns 25 percent or more of the equity interests of a legal entity customer as well as any one individual with significant responsibility to control, manage, or direct a legal entity customer. A legal-entity customer includes corporations, limited liability companies, partnerships or other similar business entities that open a new account after the implementing date of the regulation. FinCEN has requested and received over 125 comments on the notice of proposed rulemaking.

Confidentiality and disclosure of tax returns and return information under Title 26

The Code prohibits disclosure of returns and return information, except to the extent specifically authorized by the Code.[542] Tax information is defined broadly and includes a taxpayer's identity (the name of the person with respect to whom a return is filed, his mailing address, his taxpayer identifying number, or a combination thereof). Unauthorized disclosure is a felony punishable by a fine not exceeding $250,000 or imprisonment of not more than five

[539] See 31 C.F.R. sec. 1020.220(a)(2)(ii)(C). In order to assess the risk of the account relationship, a financial institution may need to ascertain the type of business, the purpose of the account, the source of the account funds, and the source of the wealth of the owner or beneficial owner of the entity.

[540] 31 C.F.R. sec. 1010.620. A private banking account is an account that (1) requires a minimum deposit of not less than 1 million dollars; (2) is established for the benefit of one or more non-U.S. persons who are direct or beneficial owners of the account; and (3) is administered or managed by an officer, employee or agent of the financial institution. Beneficial owner for these purposes is defined as an individual who has a level of control over, or entitlement to the funds or assets in the account, that enables the individual, directly or indirectly, to control, manage or direct the account. 31 C.F.R. secs. 1010.605(m), 1010.605(a).

[541] 79 Fed. Reg. 45151 (August 4, 2014).

[542] Sec. 6103.

years, or both.[543] An action for civil damages also may be brought for unauthorized disclosure.[544] Even when disclosure is authorized by the Code, no tax information may be furnished by the IRS to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives.[545]

Certain exceptions apply to the disclosure rules, including exceptions for limited disclosure for use in certain criminal investigations. When tax information is sought for a non-tax criminal law enforcement purpose, or to apprise relevant officials of suspected terrorist activities, court approval is required prior to disclosure, unless the information to be disclosed was derived from a source other than the taxpayer or received on behalf of the taxpayer.[546]

Description of Proposal

The proposal includes four provisions intended to enable Treasury to gather information related to the direct or indirect owners of U.S. companies, and to share such information efficiently with law enforcement in order to combat money laundering, terrorist financing, and other financial crimes.[547] First, the proposal requires all companies formed in the United States to obtain an EIN, which would function as a universal identifier for these companies. Second, the proposal allows the Secretary of the Treasury to share beneficial ownership[548] information with law enforcement without a court order. Third, the proposal gives the Secretary of the Treasury the authority to impose anti-money laundering and countering the financing of terrorism obligations on persons in the business of forming companies. Finally, the proposal establishes standards that States would be encouraged to adopt in order to improve their regulation and oversight of the incorporation process.

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[543] Sec. 7213; 18 U.S.C. sec. 3571.

[544] Sec. 7431.

[545] Sec. 6103(p).

[546] Secs. 6103((i)(3)(A) and 6103(i)(7)(A).

[547] The proposal is found in Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government for Fiscal Year 2015,* pp. 168-169. Although the description specifies the purpose of the proposals to assist AML/CTF efforts, presumably the reference to financial crimes includes tax crimes. The description is located under the heading "Reduce the Tax Gap and Make Reforms," and follows descriptions of several information reporting legislative proposals, including reciprocal reporting of information in connection with the implementation of FATCA, the text of the description focuses on criminal enforcement. The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), Item XVII.A.5, reprinted in the back of this volume. It is also listed as one of the elements of expanded information reporting necessary to improve tax compliance, at page 99 of the IRS budget. See http://www.treasury.gov/about/budget-performance/CJ15/10.%20-%2015.%20IRS%20CJ.pdf.

[548] Although the proposal refers to the sharing of "beneficial ownership" information, it is probable that the Administration is proposing to share "responsible party" information collected as part of the EIN application process.

Analysis

International calls for more transparency of entities has gained momentum in recent years, both in support of anti-money laundering and counter-terrorism measures and as part of efforts to improve tax reporting. Although the United States has been an active leader in developing the emerging consensus requiring transparency and information exchange, it has also been criticized for perceived shortcomings in its ability and willingness to obtain access to and share information on ownership of U.S. entities. The Administration's multi-pronged proposal appears to be an attempt to resolve, or at least allay, those concerns.

Background

With respect to the enhancement of the ability of tax authorities to gain access to information, the U.S. legislation and implementation of the provisions commonly referred to as the Foreign Account Tax Compliance Act ("FATCA")[549] as well as the OECD and G20 work on information exchange and transparency have been central to development of an international consensus on the need for improved transparency regarding financial accounts. On October 29, 2014, the OECD/G20 common reporting standard on automatic exchange of information was approved by all OECD and G20 countries at the annual meeting of the Global Forum on Transparency and Exchange of Information for Tax Purposes.[550] Although the United States did not sign the agreement, the agreement is similar to standards that the United States intends to implement under FATCA, under which the United States commits to pursuing relevant legislation to enable it to engage in meaningful reciprocal exchanges of information. The adopted standard includes provisions requiring the participating jurisdictions to ensure that their domestic laws require collection of the beneficial ownership of legal persons and arrangements, and access of that information by the legal authorities who can then exchange information.[551]

Members of the Global Forum, an international tax organization created in the early 2000s that includes 122 OECD and non-OECD member jurisdictions, undergo periodic peer reviews of their legal and regulatory framework for transparency and exchange of information in tax matters, and the implementation of those standards in practice. One of the elements reviewed is whether ownership and identity information for relevant entities is available to a jurisdiction's competent authority so that it can be exchanged with a tax treaty partner if that information is foreseeably relevant to the administration and enforcement of the treaty partner's domestic

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[549] Hiring Incentives to Restore Employment Act of 2010, Pub. L. No. 111-147. The Foreign Account Tax Compliance Act of 2009 is the name of the House and Senate bills in which the provisions first appeared. See H.R. 2933 and S. 1934 (October 27, 2009).

[550] See OECD Newsroom, "Major New Steps to Boost International Cooperation Against Tax Evasion: Governments Commit to Implement Automatic Exchange of Information Beginning 2017," available at http://www.oecd.org/newsroom/major-new-steps-to-boost-international-cooperation-against-tax-evasion-governments-commit-to-implement-automatic-exchange-of-information-beginning-2017.htm.

[551] OECD, *Standard for Automatic Exchange of Financial Account Information in Tax Matters*, 2014, p. 306.

laws.[552] In a peer review report of the United States in 2011, the Global Forum noted that for certain entities formed in the United States that have limited U.S. nexus (*e.g.*, no U.S. employees or activity, no U.S. owner, and no U.S. trade or business), information on the owner of the entity will not be available pursuant to U.S. federal tax laws.[553] In related work, the G-8 in 2013 published principles on corporate transparency, and called for national action plans from its member countries. The United States published its Action Plan for Transparency of Company Ownership and Control on June 18, 2013.[554]

International efforts to enforce anti-money laundering and counter-terrorism measures have focused on the importance of the ability to identify company ownership and control, focusing on the availability and sharing of information regarding the beneficial ownership of entities. The Financial Action Task Force ("FATF")[555] assessed the United States' anti-money laundering and counter-terrorist financing standards in 2008. The assessment found, among other things, that "Company formation procedures and reporting requirements are such that the information on beneficial ownership may not be adequate and accurate, and competent authorities would not be able to access this information in a timely basis."[556] The assessment found no legal obligation to identify beneficial owners except in very specific circumstances. The report recommended that the U.S. authorities make a review and determine ways in which adequate and accurate beneficial ownership information would be available to law enforcement authorities across all States as uniformly as possible. Additionally, it was further recommended that the Federal and State governments work together to avoid the risk of arbitrage between jurisdictions. FATF will evaluate the United States again beginning in 2016.

The international movement towards more transparency of entities for AML/CFT purposes and the move towards more transparency for tax administration purposes in addition to shortcomings in U.S. domestic law identified by FATF and the Global Forum serve as a

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[552] OECD, *The Global Forum on Transparency and Exchange of Information for Tax Purposes*, November 2013, available at http://www.oecd.org/tax/transparency/global_forum_background%20brief.pdf.

[553] Members of the Global Forum undergo periodic peer reviews of their legal and regulatory framework for transparency and exchange of information in tax matters, and the implementation of those standards in practice. OECD, *Global Forum on Transparency and Exchange of Information for Tax Purposes Peer Reviews: United States 2011: Combined Phase 1 + Phase 2*, available at http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/global-forum-on-transparency-and-exchange-of-information-for-tax-purposes-peer-reviews-united-states-2011_9789264115064-en#page1.

[554] See the White House Press release available at http://www.whitehouse.gov/the-press-office/2013/06/18/united-states-g-8-action-plan-transparency-company-ownership-and-control (hereinafter "U.S. Action Plan for Transparency").

[555] The FATF is an inter-governmental body established in 1989 to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats. The FATF issues recommendations and monitors the progress of its member jurisdictions in implementing the necessary measures to ensure the integrity of the financial system.

[556] See FATF, *Third Mutual Evaluation Report on Anti-Money Laundering and Combating the Financing of Terrorism: United States of America*, June 23, 2006, pp.236-237, available at http://www.fatf-gafi.org/media/fatf/documents/reports/mer/MER%20US%20full.pdf.

backdrop for the Administration's proposal. The proposal includes two tax-related provisions and two provisions not directly involving tax rules. These provisions are discussed below.

Tax-related provisions

The proposal includes two tax-related prongs: the requirement that all companies formed in the United States obtain an EIN and the authority for Treasury to share tax information for non-tax criminal enforcement without a court order. The scope and merits of each of these parts of the proposal are discussed below.

Expand requirement to obtain an EIN

The first tax-related provision of the proposal expands the EIN requirement to all entities formed in the United States. The Secretary has authority to require companies to provide information as necessary to assign identifying numbers to any person.[557] However, the Secretary's authority to require companies to obtain an identifying number is generally limited under present law to companies required to make a return, statement, or other document,[558] furnish a number to another person as required by the Code,[559] make a return, statement or other document with respect to another person as provided under the Code,[560] or prepare any return or claim of refund for another person.[561]

The new EIN requirement will not impose any new burden on the majority of entities formed in the United States as most are already required under present law to obtain an EIN because they are doing business in the United States. As new customers are generally required to provide EIN information to financial institutions upon the opening of an account with the financial institution, the extension of the requirement to obtain an EIN to all companies formed in the United States only expands the requirement to U.S. entities that are neither doing business nor opening bank accounts in the United States.

In the context of the global move towards transparency and identification of beneficial ownership and the global reporting standard, requiring all entities to secure an EIN is a step towards a uniform Federal identifier, but is not equivalent to requiring information on beneficial ownership. An EIN can be obtained by identifying a single responsible party. The international standards for beneficial ownership and the proposed rules under Title 31 contemplate the existence of more than one beneficial owner and in such case, require identifying all such owners. If the proposed rules are finalized, it is not clear how they would interact with the steps contemplated in this proposal. Critics may argue that the proposal is inadequate because it does

[557] Sec. 6109(c).

[558] Sec. 6109(a)(1).

[559] Sec. 6109(a)(2).

[560] Sec. 6109(a)(3).

[561] Sec. 6109(a)(4).

not commit to requiring the identification of, and reporting with respect to, all beneficial owners of legal entities. The United States did not sign the agreement to implement the OECD/G20 common reporting standard, prompting at least one commentator to argue that this could have a negative impact on U.S. financial institutions if the United States is treated as a nonparticipant.[562]

Authorize sharing of beneficial ownership information without prior judicial review

The second tax-related provision of the proposal allows Treasury to share beneficial ownership information with law enforcement personnel without a court order. In phrasing the proposal in terms of beneficial ownership, the Administration may anticipate implementation of rules that would ensure that it has access to such information. At present, it is not clear what sources of information, other than the responsible party information collected during the EIN application process, may be contemplated for sharing with other law enforcement. In its statement explaining its proposal to permit disclosure of about formation of companies, the Administration states that knowledge of beneficial owners of companies can help law enforcement officials identify and investigate criminals who form and misuse U.S. companies to launder criminal proceeds and finance terrorism through the international banking system. The rationale is that if Treasury had authority to more readily share the information it collects with law enforcement, such sharing would advance criminal investigations and successful prosecution of money laundering and terrorist financing cases and assist in identifying criminal proceeds and assets. Despite the broad statement about the benefits of sharing information on beneficial ownership among law enforcement authorities, the proposal does not necessarily remedy the problems identified by the Global Forum and FATF about the United States lack of access to the relevant information.

To the extent that such information is limited to "responsible party" information obtained as part of the process of issuing an EIN, the information is confidential return information within the meaning of section 6103 and may be disclosed to law enforcement personnel only pursuant to a court order, and only under certain circumstances, as explained in the present law section above. The proposal would allow Treasury to share this confidential return information without a court order. Opponents of the proposal may argue that the sharing of confidential responsible party information, collected as part of the EIN application process, without a court order may violate the purposes of section 6103. Prior to enactment of the Tax Reform Act of 1976,[563] the Justice Department could obtain tax information "where necessary in the performance of his official duties," or for use in litigation in which the United States was interested in the result.[564] Congress questioned whether the extent of the actual and potential disclosure of tax information for non-tax purposes was a breach of a reasonable expectation of privacy and whether the reaction to the abuse of privacy could impair the effectiveness of the U.S. voluntary tax-

[562] Rick Mitchell, Bloomberg BNA, *Daily Tax Report*, "Practitioner Sees Possible Negative Effect on Banks as U.S. Hesitates on Global Standard," October 30, 2014. See also, Stephanie Soong Johnston, Tax Analysts, *Tax Notes Today*, "Countries Sign Agreement on OECD Information Exchange Standard," October 30, 2014.

[563] Pub. L. No. 94-455 (section 1202(a)(1) amended Code section 6103 effective January 1, 1977).

[564] See S. Rep. No. 94-938 (94th Cong.), June 10, 1976 at 316.

assessment system.[565] In turn, Congress amended section 6103 to limit disclosure of tax return information other than as specifically provided. To afford the taxpayer with the appropriate degree of privacy and to balance the need for tax information in the investigation and prosecution of non-tax criminal matters, section 6103 provides for the disclosure of tax information for Federal non-tax criminal investigation purposes only pursuant to an *ex parte* court order.[566] It may be argued that by eliminating the need for prior judicial review of disclosure of return information for non-tax purposes, the proposal could undermine the ability to collect information and issue EINs for tax purposes if taxpayer non-compliance with the EIN application requirements increases due to privacy concerns.

Non-tax provisions

There are two non-tax provisions of the proposal: grant authority to the Secretary of the Treasury to impose AML/CFT obligations on persons in the business of forming companies, and establish Federal standards that States would be encouraged to adopt to improve the regulation and oversight of the incorporation process. Both provisions impose the Federal government in what is, under present law, generally under the purview of the States, *i.e.*, the formation of legal entities.

Imposition of AML/CTF sanctions on persons engaged in formation of legal entities

The proposal to impose AML/CTF standards on persons engaged in the formation of legal entities would apparently extend the criminal sanctions imposed under Title 31, with a goal to deter persons from assisting in the formation of entities that are the target of this collection of proposals. In support, proponents of the proposal may argue that imposing appropriate and risk-based AML/CFT requirements on those in the business of forming companies, *i.e.* company formation agents, is an important measure to mitigate the misuse of companies. In view of the fact that formation agents have direct contact with those seeking their services, AML/CFT requirements could potentially aid in preventing the formation of legal entities for illicit purposes and could also provide law enforcement with access to important records. As such, proponents may argue that this proposal is in some measure a response to international criticism of the United States regarding its ability to gather information needed to investigate, prevent and prosecute money laundering, terrorist financing, and other financial crimes.

Opponents may argue the proposal imposes new obligations and costs on persons in the business of forming companies. Furthermore, requiring law firms or other service organizations involved in the formation of entities to comply with AML/CFT obligations would increase the cost of forming entities. These costs could fall on small businesses within the United States.

[565] *Ibid.* at 317.

[566] Sec. 6103(i).

Development of Federal standards for use by State governments

The final provision of the proposal calls for the establishment of standards that States would be encouraged to adopt to improve their regulation and oversight of the incorporation process. It is not clear under the proposal what body would establish Federal standards and whether this provision would require new legislation.

Proponents may argue that Federal standards are necessary for the regulation and oversight of the entity formation process in order for the United States to meet its international obligations. As part of its G-8 Action Plan for Transparency of Company Ownership and Control, the United States committed to continue to advocate for comprehensive legislation to require identification and verification of beneficial ownership information at the time a company is formed.[567] This proposal is consistent with that commitment.

Opponents of the proposal may argue that the establishment of Federal standards regarding entity formation for adoption by the States is inappropriate, because the legal entities are creatures of State governments, which should retain full autonomy in establishing regulations and oversight of the entity formation process. Some opponents oppose current Federal legislation aimed at changing the company formation process in the United States.[568]

It is possible that the Administration contemplates that the proposal for States to adopt standards on regulation and oversight of the incorporation process would be voluntary in nature. Proponents may argue that a voluntary system encouraging States to adopt measures or best practices to improve the regulation and oversight of the company formation process is wholly consistent with our Federal system in which States are responsible for company formation. However, if the proposal contemplates a wholly voluntary system, some States may choose not to adopt the new regulation and oversight, allowing States to compete against the other States for formation fees, perhaps encouraging a "race to the bottom."

B. Improve Compliance by Businesses

1. Require greater electronic filing of returns

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 580-582. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.B.1, reprinted in the back of this volume.

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[567] See U.S. Action Plan for Transparency.

[568] See, *e.g.*, National Association of Secretaries of State Company Formation Task Force, *Report and Recommendations on Assisting Law Enforcement in Fighting the Misuse of Corporate Entities*, September 2012.

2. Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 585-590. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.B.2, reprinted in the back of this volume.

3. Increase certainty with respect to worker classification

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 591-610. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.B.3, reprinted in the back of this volume.

4. Increase information sharing to administer excise taxes

Present Law

Generally, tax returns and return information ("tax information") are confidential and may not be disclosed unless authorized in the Code.[569] Return information includes data received, collected or prepared by the Secretary with respect to the determination of the existence or possible existence of liability of any person under the Code for any tax, penalty, interest, fine, forfeiture, or other imposition or offense. Criminal penalties apply for the unauthorized inspection or disclosure of tax information. Willful unauthorized disclosure is a felony under section 7213 and the willful unauthorized inspection of tax information is a misdemeanor under section 7213A. Taxpayers may also pursue a civil cause of action for disclosures and inspections not authorized by section 6103.[570]

Section 6103 provides exceptions to the general rule of confidentiality, detailing permissible disclosures. Under section 6103(h)(1), tax information is open to inspection by or disclosure to Treasury officers and employees whose official duties require the inspection or disclosure for tax administration purposes. Under section 6103(o), tax information with respect to taxes on alcohol, tobacco and firearms is open to inspection by or disclosure to officers and employees of a Federal agency whose official duties require such inspection or disclosure.

[569] Sec. 6103(a).

[570] Sec. 7431.

The Alcohol and Tobacco Tax and Trade Bureau ("TTB") is a bureau under the Treasury. The TTB collects Federal excise taxes on alcohol, tobacco, firearms, and ammunition and ensures compliance with Federal tobacco and alcohol permitting, labeling, and marketing.

Prior to 2003, customs officials who had responsibilities for enforcing and/or collecting excise taxes on imports were employees of the Treasury Department. Thus, prior to 2003, section 6103(h)(1) allowed disclosure of tax information by the IRS and TTB to these customs officials in the performance of their duties. In 2003, U.S. Customs and Border Protection became an official agency of the U.S. Department of Homeland Security.[571] At that time, Customs and Border Protection employees ("customs officials") were transferred from Treasury to the Department of Homeland Security. While the U.S. Customs Service moved from Treasury to the Department of Homeland Security, the authority to collect excise taxes remains with Treasury.[572]

Description of Proposal

The proposal would add employees of the Department of Homeland Security (customs officials) involved in tax administration to the list of federal officers and employees to whom the IRS and TTB may disclose tax returns and return information.

Effective date.−The proposal is effective on the date of enactment.

Analysis

As discussed above, present law section 6103(h) is not limited on the types of return information available to Treasury personnel for tax administration purposes. The information available to any Federal agency provided in present law section 6103(o) is limited to taxes imposed under subtitle E (Alcohol, Tobacco, and Other Excise Taxes). The Administration argues that the transfer of customs officials from the Department of Treasury to the Department of Homeland Security resulted in limitations on the information that the IRS and TTB might share with customs officials, thus hindering effective administration and enforcement of excise tax laws. By allowing the limited disclosure of tax return information to customs officials, the Administration believes the proposal would facilitate tax administration and improve compliance with excise tax laws.

As section 6103(o) is limited to certain excise taxes imposed under subtitle E, proponents may argue that the authority to share information with other Federal agencies should be extended to cover other excise taxes imposed under subtitle D (Miscellaneous Excise Taxes). It is not clear from the proposal how information sharing beyond the tax information already authorized by section 6103(o) would impact tax compliance with respect to other excise taxes, and further

[571] The Homeland Security Act of 2002, Pub. L. 107-296 ("Homeland Security Act"), enacted November 25, 2002, established the U.S. Department of Homeland Security. Several agencies were combined under this new department.

[572] Sec. 412 of the Homeland Security Act.

specification of the use of tax information by customs officials is needed to fully analyze the merits of this proposal.

C. Strengthen Tax Administration

1. Impose liability on shareholders to collect unpaid income taxes of applicable corporations

Description of Modification

The fiscal year 2014 budget proposal is modified by adding a new section to the Internal Revenue Code that would impose on shareholders who sell the stock of an "applicable C corporation" secondary liability (without resort to any State law) for payment of the applicable C corporation's income taxes, interest, additions to tax, and penalties to the extent of the sales proceeds received by the shareholders.[573] The modification applies to shareholders who, directly or indirectly, dispose of a controlling interest (at least 50 percent) in the stock of an applicable C corporation within a 12-month period in exchange for consideration other than stock issued by the acquiror of the applicable C corporation stock. The secondary liability would arise only after the applicable C corporation was assessed income taxes, interest, additions to tax, and penalties with respect to any taxable year within the 12-month period before or after the date that its stock was disposed of and the applicable C corporation did not pay such amounts within 180 days after assessment.

For purposes of the modification, an applicable C corporation is any C corporation (or successor) two thirds or more of whose assets consist of cash, passive investment assets, or assets that are the subject of a contract of sale or whose sale has been substantially negotiated on the date that a controlling interest in its stock is sold. The modification would grant the Treasury Department authority to prescribe regulations necessary or appropriate to carry out the proposal.

The modification would not limit the government's ability to pursue any cause of action available under current law against any person.

The modification would be effective for sales of controlling interests in the stock of applicable C corporations occurring on or after April 10, 2013.[574]

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[573] The fiscal year 2014 budget proposal is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 163-171. The estimated budgetary effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.1.

[574] It is understood that the effective date of the current proposal refers to the date of publication of the fiscal year 2014 budget proposal.

Analysis

The modification differs from the fiscal year 2014 budget proposal in that it defines the transactions to which it applies using a bright line rule and does not depend on interpretation of state law or on a finding that there has been a "plan" to avoid tax. The modification generally applies only to cases in which business assets have already been sold, (or the sale substantially negotiated) at the time a stock purchaser buys control of the corporation, though it also covers cases in which at least two-thirds of a corporation's assets are passive investment assets, whether or not such assets have been sold or a sale substantially negotiated.[575] Critics might contend that the fact that two thirds of corporate assets are passive investment assets should not determine whether selling shareholders are subject to liability for unpaid corporate taxes following a sale of the corporate stock.

Further definition of a number of terms would be necessary if the proposal were to be adopted. For example, the definition of "passive investment assets" would be important. The Code provides a number of potential analogous definitions,[576] but Congress may wish to provide a specific definition applicable for this purpose.[577]

The definition of when a 50-percent or greater controlling interest has been, directly or indirectly, disposed of by shareholders also would require specification. For example, it could be clarified whether this test requires a disposition only of voting power, or would also apply to a disposition of 50 percent of the value of stock, including perhaps the value of non-voting preferred shares. It could also be clarified whether the disposition trigger requires any action in concert, or merely refers to the fact that disposition of a 50-percent or greater interest occurs within the specified time period. Attribution rules could be provided for clarity. The sale of stock of public corporations (and purchase by public corporations) is generally excluded from the proposal, so some complexities attending attribution and tracking transactions would be avoided. Again, the Code provides possible analogous definitions,[578] but Congress would need to provide a specific definition applicable for this purpose.

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[575] One example would be a situation in which no assets of the corporation had ever been sold in a taxable transaction, but such assets had always been passive assets. See, *e.g.*, *Julia R. Swords Trust, Transferee, Margaret R. Mackell, Dorothy R. Brotherton, and Julia R. Swords, Co-Trustees, et. al. v. Commissioner*, 142 T.C. No. 19 (May 29, 2014). The sole corporate asset in that case was stock of a public corporation, placed by that corporation's founder into a personal holding company, the stock of which was owned by his heirs. The Tax Court held that the heirs did not have transferee liability under applicable state law when they sold the personal holding company stock to a "financial buyer" whose unusual tax situation (specifics unknown to the sellers) enabled it to pay the sellers 90 percent of the fair market value of the underlying public stock, without discount for taxes that would attend a sale of the public stock.

[576] See, *e.g.*, the definition of personal holding company income for purposes of the personal holding company rules (sec. 543); the definition of passive assets for purposes of the PFIC rules (sec. 1248 and sec 954(c)); and the definition of investment assets for purposes of the disqualified investment corporation rules (sec. 355(g)).

[577] The question whether a sale of assets has been "substantially negotiated" is likely to be a question of fact, though guidance might be provided.

[578] See, *e.g.*, sec. 355(e).

If the two-thirds-of- assets test is to applied by reference to the fair market value of assets, valuation of assets would be required. The relatively high threshold, however, might limit the number of cases in which valuation was considered necessary.

Adoption of the modified proposal might deter the entry of many of the types of transactions that the IRS has been targeting. A selling shareholder might require indemnifications from a stock purchaser, relating to transactions occurring within a year of the shareholder's stock sale. It is possible that this might deter purchasers who intend to enter possibly questionable transactions in an attempt to offset gain from an asset sale and report no tax liability.

It is still possible that selling shareholders may wish to obtain indemnifications in a broader range of situations than those to which the modified proposal would actually apply. For example, depending on the definition of the disposition of a 50-percent or greater interest, a relatively small shareholder that disposes of its interest, even in a corporation that does not meet the asset tests, might wish to protect itself against the possibility that, within 12 months, enough other shares may be disposed of to satisfy the 50 percent test, and that the asset composition may have changed by the date such percent threshold is crossed. The exclusion of publicly traded entities may significantly reduce the number of cases in which this could occur. However, it is unclear whether a small stock seller, who sells to a purchaser that may never obtain control of the corporation whose stock was sold, would seek some type of reassurance that his sale would not incur liability under the proposal. Consideration might be given to whether de minimis or other rules might be considered to address this type of situation, and whether such rules would retain adequate protection against the targeted cases.

The proposal, with further clarifications and definition, could provide Treasury with greater ability to collect tax in the types of cases that have sometimes proven difficult. Some might, however, contend that the statute or Treasury should not provide conclusive presumptions, but that determinations should continue to be made based upon all the facts and circumstances and using applicable state law.

2. Increase levy authority for payments to Medicare providers with delinquent tax debt

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal and the President's fiscal year 2013 budget proposal. For a description of this proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 734-737. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.2, reprinted in the back of this volume.

3. Implement a program integrity statutory cap adjustment for tax administration

Description of Modification

The fiscal year 2014 budget proposal is modified by adjusting the discretionary spending limits for IRS tax enforcement, compliance, and related activities, including tax administration

activities at the Alcohol and Tobacco Tax and Trade Bureau.[579] This proposal funds approximately $480 million in new enforcement and compliance initiatives in fiscal year 2015, provides additional funding for new enforcement and compliance initiatives in each fiscal year between 2016 and 2019, and funds all of the new initiatives and inflationary costs via cap adjustments through fiscal year 2024. The total projected cost of the proposal is $17 billion through fiscal year 2024.

4. Streamline audit and adjustment procedures for large partnerships

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 616-626. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.5, reprinted in the back of this volume.

5. Revise offer-in-compromise application rules

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 626-631. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.6, reprinted in the back of this volume.

6. Expand IRS access to information in the National Directory of New Hires for tax administration purposes

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 631-632. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.7, reprinted in the back of this volume.

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[579] The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 732-733, and is modified by the fiscal year 2014 budget proposal, described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 172. The estimated budgetary effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C. 20, reprinted in the back of this volume.

7. Make repeated willful failure to file a tax return a felony

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 633-635. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.8, reprinted in the back of this volume.

8. Facilitate tax compliance with local jurisdictions

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 635-637. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.9, reprinted in the back of this volume.

9. Extend statute of limitations where State adjustment affects Federal tax liability

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 637-640. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.10, reprinted in the back of this volume.

10. Improve investigative disclosure statute

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 640-641. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.11, reprinted in the back of this volume.

11. Require taxpayers who prepare their returns electronically but file their returns on paper to print their return with a scannable code

Description of Modification

The fiscal year 2014 budget proposal is modified in two ways. First, the proposal is modified by providing the Secretary with regulatory authority to require taxpayers who prepare their returns electronically but print and file the returns on paper to print their returns with a

scannable code. In other words, under this modification, the scannable code would only be required to the extent the Secretary so provides. The proposal is also modified by requiring a scannable code as opposed to a 2-D bar code, referenced in the previous proposal. The scannable code program enables the IRS to convert paper-filed tax returns into an electronic format using scanning technology.[580]

12. Allow the IRS to absorb credit and debit card processing fees for certain tax payments

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 644-646. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.13, reprinted in the back of this volume.

13. Provide the IRS with greater flexibility to address correctable errors

Description of Modification

In the fiscal year 2015 budget proposal, IRS authority to assess tax notwithstanding the restrictions on assessments[581] is changed by replacing the existing exceptions for math error authority with the following two exceptions: (1) math errors, redefined to include only errors in computation or use of a table provided by the IRS and (2) errors identified in regulations as "correctable errors." Correctable errors are those that reflect deductions or credits claimed in excess of a lifetime limit, discrepancies between information provided by the taxpayer and information in government databases, or taxpayer failures to provide statutorily required documentation.[582] The proposal is to be effective upon date of enactment, except that assessment authority based on correctable errors is dependent upon promulgation of final regulations rather than self-executing. In contrast, the prior year budget proposal retained all present law exceptions to the restrictions on assessment, and added two exceptions for (1) instances in which a taxpayer claimed a deduction or credit in excess of a lifetime limit and (2) instances in which a taxpayer claimed the earned income tax credit during a period in which a

[580] The fiscal year 2014 budget proposal is identical to the fiscal year 2013 budget proposal. The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 642-644. The estimated budgetary effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.12, reprinted in the back of this volume.

[581] Section 6213(b) contains an exception to the deficiency procedures that provides the IRS authority to correct certain mathematical or clerical errors made on tax returns. This authority is generally referred to as "math error authority."

[582] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.14, reprinted in the back of this volume.

taxpayer is not permitted to claim such credit as a consequences of having made a prior reckless or fraudulent claim.

Analysis

The modified proposal presents the same issues regarding how to balance the need for efficient allocation of government resources with the need for adequate taxpayer safeguards that were presented by the proposal for fiscal years 2013 and 2014.[583] By replacing all existing exceptions other than purely computational or clerical errors with the authority to promulgate regulations, the assessment authority under the modified proposal is potentially greater than either existing law or the expansions previously requested. Although the criteria that is proposed to set the parameters on the discretion to identify correctable errors includes one of the earlier proposed exceptions that attracted little dispute (claims for deduction or credit in excess of a lifetime limit), the other specific factors for inclusion in the category of correctable error (failure to provide statutorily required documentation and discrepancies between returns and government databases) are potentially overbroad. Failure to provide statutory required documentation underlies several of the exceptions in present law that would be displaced by the proposal, all of which are now tied to specific credits or deductions. It is not clear whether the proposal anticipates that any regulatory exception thereunder must be similarly linked to a specific statutory requirement that documentation accompany returns, or if the exception to restrictions on assessments could also be based upon regulatory rules on the manner for filing.

In support of the modified proposal, the Administration asserts that the proposal would permit the IRS to efficiently allocate its resources in response to emerging issues. The Administration contends that permitting it to identify by regulation those errors that warrant an exception to the restrictions on assessment is necessary because legislative action may not be timely. Proponents reason that, if the IRS is permitted to identify what constitutes a corrective error, it may arrive at a regulatory solution in a shorter period of time than would be required to obtain comparable legislative action on a case-by-case basis as new issues are identified. In response, critics of the proposal may note that lack of favorable action on Administration requests is not necessarily due to inattention and that failure to adopt a proposal may have been deliberate. The rationale provided by the Administration gives little weight to the fact that Congress has expanded the exceptions to restrictions on assessment numerous times since the original math error authority for summary assessment was enacted.[584] No reason is provided for concluding that the policy choices required in identifying correctable errors is best left to the Secretary alone, rather than the legislative branch.

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[583] A description of present law and an analysis of the earlier budget proposal are included in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, p. 649. That proposal was included, without change, in the fiscal year 2014 budget.

[584] The exception to the restriction on assessment originally was limited to mathematical errors, and was expanded to include clerical or transcription errors, then further expanded to address various specific cases, to reach the 16 categories of errors within the scope of the exception. See section 6213(g)(2)(A) through (P).

Finally, the proposal does not explain the basis for the conclusion that all governmental databases may be considered sufficiently reliable to warrant a conclusion that a mismatch between the database and information on a return is a correctable error. The premise that a discrepancy between information in a government database and a return is adequate grounds on which to permit a summary assessment is contrary to other provisions in the Code that suggest that the mere inclusion of information in a government database is insufficient to support a potential adjustment to a return.[585]

14. Make e-filing mandatory for exempt organizations

Description of Modification

The fiscal year 2015 budget proposal modifies the prior year budget proposal mandating e-filing of Forms 990 series returns by extending the mandate to the filing of Form 8872, "Political Organization Report of Contributions and Expenditures." Form 8872 is required to be filed by a political organization that claims tax-exempt status under section 527, and has (or expects to have) annual contributions or expenditures in excess of $50,000.

The fiscal year 2015 budget proposal further modifies the prior year budget proposal by specifying that Forms 8872 are to be made publicly available by the IRS in a machine readable format in a timely manner.[586]

15. Authorize the Department of Treasury to require additional information to be included in electronically filed Form 5500 annual reports and electronic filing of certain other employee benefit plan reports

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 161-162. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.16, reprinted in the back of this volume.

[585] See section 6201(d), which requires reasonable verification of information returns in any Court proceeding if a taxpayer asserts a reasonable dispute with respect to any item of income on an information return.

[586] The fiscal year 2014 budget proposal is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 157-160. The estimated budgetary effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.15, reprinted in the back of this volume.

16. Impose a penalty on failure to comply with electronic filing requirements

Description of Modification

The fiscal year 2014 budget proposal is modified by allowing the penalty to be waived if it is shown that failure to file electronically is due to reasonable cause.[587]

17. Provide whistleblowers with protection from retaliation

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 175. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.18, reprinted in the back of this volume.

18. Provide stronger protection from improper disclosure of taxpayer information in whistleblower action

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 176-177. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.19, reprinted in the back of this volume.

19. Index all penalties for inflation

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 178. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.20, reprinted in the back of this volume.

[587] The fiscal year 2014 budget proposal is identical to the fiscal year 2013 budget proposal. The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 654-656. The estimated budgetary effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.17, reprinted in the back of this volume.

20. Extend paid preparer earned income tax credit due diligence requirements to the child tax credit

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 179-183. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.21, reprinted in the back of this volume.

21. Extend IRS authority to require a truncated Social Security number on Form W-2

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 184-185. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.22, reprinted in the back of this volume.

22. Penalties for tax identity theft crimes

There are two proposals for penalties relating to tax identity theft crimes. The proposals are to: (i) add tax crimes to the aggravated identity theft statute; and (ii) impose a civil penalty on tax identity theft crimes.

Present Law

The Code does not contain civil or criminal penalties specifically targeted at identity theft. Instead, most claims for tax refund related identity theft are prosecuted as false claims under Title 18, section 287 and are classified as felonies, generally punishable by a penalty of up to $250,000 and imprisonment for up to five years. In addition, title 18, section 1028A, provides for the statutory crime of "aggravated identity theft" in cases where the identity of another individual is used to commit enumerated crimes and generally adds an additional two year prison term (herein the "Aggravated Identity Theft Statute"). However, that section does not cover or specifically carves out any tax offenses under the Code or tax-related offenses under Title 18, including conspiracy to defraud the government with respect to claims, false, fictitious or fraudulent claims, or conspiracy.

The Code does contain two provisions, sections 7206 and 7207 that cover fraud and false statements and fraudulent returns but generally only sections 7206(1), (2) cover situations that could potentially involve identity theft. Those provisions makes it a felony, punishable by a penalty of up to $100,000 ($500,000 for a corporation), imprisonment for up to three years, or both, plus prosecution costs, for a person to: (i) make a false declaration under penalties of perjury; and (ii) aid or assist in the preparation or presentation of any return or other document that is false as to a material matter. Section 7207 of the Code treats as a misdemeanor the willful delivery or disclosure to any officer or employee of the IRS of fraudulent or false lists, returns,

accounts, statements, or other documents, punishable by a penalty of up to $10,000 ($50,000 for corporations), imprisonment for up to a year, or both. However, this penalty is generally applied to taxpayers who provide false documents to revenue agents during an audit.

Description of Proposal

The proposal to add tax crimes to the aggravated identity theft statute adds the tax-related offenses in Title 18 and the criminal tax offenses in the Code to the list of predicate offenses contained in the Aggravated Identity Theft Statute.[588]

The proposal to impose a civil penalty on tax identity theft crimes adds to the Code an immediately assessable, separate civil penalty of $5,000 for each fraudulent return or refund claim filed by any person. There is no maximum penalty amount that may be imposed.

Effective date.−Both proposals are effective upon date of enactment.

Analysis

In a press release detailing its annual "Dirty Dozen" list of tax scams, the IRS listed tax-related identity theft as the number one tax scam for 2013.[589] Tax-related identity theft takes place through refund and employment fraud. In refund fraud, an unauthorized person uses a taxpayer's personal information, such as name, Social Security number (SSN), or other identifying information to file a tax return and claim a refund. The IRS often becomes aware of the fraudulent filing after the legitimate taxpayer files a return. In employment fraud, an unauthorized person uses a taxpayer's name and SSN to obtain a job. The IRS subsequently receives income information from the unauthorized person's employer.

According to the Government Accountability Office, the IRS identified 641,690 refund-related identity theft incidents as of September 2012 as compared to 242,142 incidents in 2011.[590] At the same time, the Treasury Inspector General reported that during the 2011 Filing Season, 1.5 million undetected tax returns had been filed by identity thieves with potentially

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[588] This proposal is identical to the fiscal year 2014 budget proposal. The estimated budgetary effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.23 and Item XVII.C.24, reprinted in the back of this volume.

[589] IRS Press Release, IR-2013-33 (March 26, 2013), available at http://www.irs.gov/uac/Newsroom/IRS-Releases-the-Dirty-Dozen-Tax-Scams-for-2013.

[590] Total Extent of Refund Fraud Using Stolen Identities is Unknown, GAO-13-132T. According to the IRS Taxpayer Advocate Service, refund-related identity theft as tracked by the inventory received by the Identity Protection Specialized Unit has risen from 253,051 in 2011 to 449,809 in 2012, an increase of 77.8 percent. Also, identity theft cases amounted to 25 percent of all case receipts for the Taxpayer Advocate Service in 2012. Taxpayer Advocate Service, 2012 Annual Report to Congress, Vol. One, the Most Serious Problems Encountered by Taxpayers (MSP #4), "The IRS Has Failed to Provide Effective and Timely Assistance to Victims of Identity Theft," pp. 42-43.

fraudulent tax refunds in excess of $5 billion.[591] As of December 31, 2012, the IRS identified almost 1.8 million incidents of identity theft during calendar year 2012.[592] This figure includes approximately 280,000 incidents in which taxpayers contacted the IRS alleging that they were victims of identity theft, and more than 1.5 million incidents in which the IRS detected potential identity theft.[593]

Proponents of the proposal to add tax crimes to the aggravated identity theft statute may argue that this change is needed to address the growing concern over identity theft in general and the growth in the number of such cases being handled by the IRS. They may point out that adding tax offenses to the list of predicate offenses for aggravated identity theft would increase the severity of the penalty available to prosecute identity thieves. However, the prison term tool of five years is already available for false claims under title 18 such that adding the possibility of two more years does not seem to create a meaningful difference.

Proponents of this proposal may argue that the Code does not provide for criminal punishment for identity theft so this provision is necessary to help deter tax related identity theft. On the other hand, the law (albeit outside the Code) already provides for a maximum penalty of $250,000 and five years in prison. Therefore, it is not clear that the person undeterred by current law would be deterred by the potential for an increased prison sentence.

Proponents of this proposal to impose a civil penalty on tax identity theft crimes may argue that this civil penalty is needed to address the growing concern over identity theft in general and the growth in the number of such cases being handled by the IRS. They may further argue that civil penalties can be imposed at a lower cost than criminal prosecutions and therefore are necessary for tax-identity theft cases to conserve IRS resources.

Proponents of this proposal may also argue that the Code does not contain civil penalties specifically targeted at identity theft so adding a civil penalty statute, whose elements arguably can be established more easily due to the lower burden of proof, is necessary to help deter tax-related identity theft. On the other hand, the law (albeit outside the Code) already provides for a maximum penalty of $250,000. Therefore, it is not clear that the person undeterred by current law would be deterred by an addition of a new civil Code penalty of $5,000. But proponents may also point out that the proposal is a $5,000 penalty per fraudulent return, with no maximum. Thus, since perpetrators tend to file hundreds or even thousands of fraudulent returns, the potential penalty amount could increase quite significantly. While a $5,000 penalty may not be much of a deterrent, a $500,000 civil penalty on the person who filed 100 fraudulent returns may be.

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[591] Testimony of J. Russell George, Treasury Inspector General for Tax Administration, House Committee on Oversight and Government Reform, Subcommittee on Government Organization, Efficiency, and Financial Management, "Identity Theft and Tax Fraud: Growing Problems for the Internal Revenue Service, Part IV," November 29, 2012.

[592] Testimony of J. Russell George, Treasury Inspector General for Tax Administration, Senate Special Committee on Aging, "Tax-Related Identity Theft: An Epidemic Facing Seniors and Taxpayers," April 10, 2013.

[593] *Ibid*.

23. Allow States to send notices of intent to offset Federal tax refunds to collect State tax obligations by regular first-class mail instead of certified mail

Present Law

Present law requires that a State notify a taxpayer before the State garnishes the taxpayer's Federal income tax refund to offset a delinquent State income tax obligation. By statute, the notice must be sent by certified mail with return receipt and the taxpayer must be given 60 days to present evidence to the State that all or part of the debt is not past-due or legally enforceable.[594] Notice by certified mail prior to offset for other types of debt is not required under the Code, including Federal nontax debt, unpaid child support, and State unemployment insurance compensation debt.[595]

Description of Proposal

The proposal removes the statutory requirement that States use certified mail to notify taxpayers prior to garnishing Federal income tax returns. Taxpayers must still be notified under the proposal, but States may use first class mail, rather than certified mail to affect such notice.[596]

Effective date.−The proposal is effective on the date of enactment.

Analysis

Certified mail provides the sender a record of mailing and a record of delivery. Certified mail is assigned a tracking number so the Postal Service can record when the mail was delivered. If return receipt is requested a copy of the recipient's signature is obtained at the time the certified mail; the Postal Service provides this signature to the sender. Because certified mail provides proof of mailing and of delivery, the IRS is required by the Code to use certified mail in various circumstances, including for time-sensitive letters that carry a taxpayer's appeal rights.[597] For this reason, opponents of this proposal may argue that a taxpayer subject to offset due to a State income tax liability should be similarly entitled to notification by certified mail of the

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[594] Sec. 6402(e)(4).

[595] The statute is silent as to notice delivery method with respect to these debts. See generally sec. 6402.

[596] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.25, reprinted in the back of this volume.

[597] For example, if a tax balance has become delinquent to the point where it has been turned over to collections, then a final notice is required under Code section 6330(a)(2)(C) to be sent certified mail to a taxpayer's last address on file. The letter entitled Final Notice - Notice of Intent to Levy and Your Notice of a Right to a Hearing notifies taxpayers of their appeal rights, which generally need to be exercised within 30 days of the date on the notice. Similarly, a notice advising of an intent by the IRS to assess a taxpayer balance must be sent by certified delivery under section 6212. This notice, referred to as a Notice of Deficiency, informs a taxpayer of a tax deficiency and advising a taxpayer of his appeal rights with the United States Tax Court.

State's intentions and the taxpayer's appeal rights. This requirement helps to ensure that the taxpayer has adequate notice of the pending offset.

Proponents of the proposal argue that the requirement is expensive and not necessary because taxpayers already receive multiple notices about their state income tax debts prior to inclusion in the Federal tax refund offset program.[598] Proponents also argue that there is no evidence that certified mail is more likely to reach the taxpayer than regular first class mail.[599] Proponents further argue that notice by certified mail prior to offset for other types of debt is not required, including Federal nontax debt, unpaid child support, and State unemployment insurance compensation debt.[600]

24. Explicitly provide that the Department of the Treasury and the Internal Revenue Service ("IRS") have authority to regulate all paid return preparers

Present Law

Tax Return Preparers Under the Internal Revenue Code

Tax assessment and collection in the United States depends on the voluntary compliance of taxpayers. In recent years, a significant and steadily increasing number of taxpayers discharge their duty to prepare and timely file accurate tax returns by seeking the advice and assistance of a paid tax return preparer.[601] For example, individual taxpayers filed about 142 million returns for tax year 2011, with nearly 79 million returns using paid tax return preparers.[602] Thus, the competence and professionalism of tax return preparers has an impact on taxpayer compliance. The Code subjects paid tax return preparers to various statutory standards of return preparation, obligations to make certain disclosures, and civil penalties for failure to comply.

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[598] Government Accountability Office, *Tax Administration: Possible Implications of Expanding Refund Offset Provisions* (GAO-09-571R), May 7, 2009, p.6, fn. 18 (GAO notes what GAO was told by Federal Tax Administrators).

[599] Federation of Tax Administrators Resolutions 2013, Resolution 2013-1, Supporting Expansion of Federal Refund Offset for State Tax Debts, available at http://www.taxadmin.org/fta/meet/13am/Resolutions_2013.pdf.

[600] *Ibid*.

[601] See Internal Revenue Service, Statistics of Income Bulletin, Historical Table 22, Number of Returns with a Paid Preparer Signature, Fiscal Years 2000-2011, available at http://www.irs.gov/uac/SOI-Tax-Stats-Historical-Table-22.

[602] IRS Compliance Data Warehouse, Individual Returns Transaction File and Return Preparers and Providers Database, TY 2011 (Mar 2013), as reported in Taxpayer Advocate Service, *2013 Annual Report to Congress*, vol. 1, page 61, available at http://www.taxpayeradvocate.irs.gov/2013-Annual-Report/full-2013-annual-report-to-congress/?vsmaid=11. This data only includes tax returns that are signed by paid tax return preparers. Thus, the data likely underestimates the number of Americans utilizing paid tax return preparers because many tax return preparers fail to sign tax returns, notwithstanding the penalty provided in section 6695(b) of the Code.

The Code broadly defines the term "tax return preparer" as any person who prepares for compensation, or who employs other people to prepare for compensation, all or a substantial portion of a tax return or claim for refund.[603] A person is considered a tax return preparer when one prepares a substantial portion of a return, regardless of whether the person signs the return.[604] There are no specific educational or professional credentials required to be subject to the rules applicable to tax return preparers.[605] Persons whose duties are merely mechanical or clerical (such as keying in data, typing schedules, printing, or producing copies) are excepted from the definition of tax return preparers, as are IRS officials acting in the course of their official duties and certain volunteers.

While the Code provides standards of return preparation, disclosure rules, and civil penalties, neither the Code nor the related Treasury regulations require paid tax return preparers to meet any qualifications or competency standards before preparing tax returns or claims for refund.[606] Title 31 of the U.S. Code ("Title 31"), however, does regulate certain paid tax return preparers such as attorneys, certified public accountants ("CPAs"), enrolled agents, enrolled retirement plan agents, and certain other individuals. Because an increasing number of taxpayers use paid return preparers who are not regulated, the IRS has issued guidance that would extend these rules to such preparers.

Tax Return Preparers Under Treasury Regulations

Some, but not all, paid tax return preparers are regulated currently under Title 31 which authorizes the Secretary to regulate the practice of representatives before the Treasury. Under this authority, the Treasury Department has issued regulations in Treasury Department Circular No. 230 ("Circular 230"). Circular 230 provides that only attorneys, CPAs, enrolled agents, enrolled actuaries, enrolled retirement plan agents, and certain other specified individuals who meet certain requirements may practice before the IRS. Circular 230 authorizes the Director of the Office of Professional Responsibility to act on applications for enrollment to practice before the IRS, to make inquiries with respect to matters under the Director's jurisdiction, to institute and provide for the conduct of disciplinary proceedings relating to practitioners and appraisers, and to perform such other duties as necessary to carry out those functions.[607]

Prior to 2011, Circular 230 did not apply to an individual tax return preparer unless that person was an attorney, CPA, enrolled agent, enrolled actuary, enrolled retirement plan agent, or other type of practitioner defined in Circular 230. Thus, any individual could prepare tax returns

[603] Sec. 7701(a)(36)(A); Treas. Reg. sec. 301.7701-15(a).

[604] Treas. Reg. sec. 301.7701-15(b).

[605] Treas. Reg. sec. 301.7701-15(d).

[606] However, these tax return preparers may be subject to State educational or testing (or both) requirements if they live in States that regulate tax return preparers, such as California, Maryland , New York, and Oregon. See IRS Publication 4832, *Return Preparer Review*, December 2009, p. 18.

[607] Circular 230, sec. 10.1.

and claims for refund without meeting the qualifications and competency standards provided in Circular 230. In June 2009, the IRS initiated a review of tax return preparers to ensure consistent standards of conduct for all tax return preparers and to increase taxpayer compliance. During this process, the IRS received input from the public and provided its findings in a report recommending increased oversight of the tax return preparer industry through regulations.[608]

In 2011, the IRS issued implemented its recommendations by issuing regulations under Circular 230 to regulate paid tax return preparers who were previously not covered.[609] These new regulations provide that only attorneys, CPAs, enrolled agents, and a new category, registered tax return preparers, may prepare tax returns for compensation.[610] Moreover, the regulations provide that any individual who is compensated for preparing or assisting with the preparation of all or substantially all of a tax return or refund claim is a practitioner, subject to Circular 230 requirements, and subject to sanction for violating the requirements.[611] Therefore, any individual who prepares a tax return for compensation and who is not an attorney, CPA, or enrolled agent must obtain registered tax return preparer status.[612] A registered tax return preparer is any individual designated as such under Circular 230 who is not under suspension or disbarment from practice before the IRS.

The regulations require an individual who seeks to be a registered tax return preparer to pass a competency exam or otherwise satisfy standards prescribed by the IRS,[613] to attend

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[608] IRS Publication 4832, *Return Preparer Review*, December 2009.

[609] T.D. 9527, Fed. Reg. 32286, Vol. 76, No. 107, June 3, 2011. The regulations now include a definition of "tax return preparer" that is consistent with use of that term in the Code (see discussion in section A of this part, above). The regulations also require all preparers to obtain a "preparer tax identification number" ("PTIN") and to use such number on all returns with respect to which the person is considered a tax return preparer. The use of a preparer tax identification number was specifically authorized in section 6109(a)(4), which provides that such number must be included on all returns or claims for refund, when required by regulations prescribed by the Secretary.

[610] Circular 230, sec. 10.8(a).

[611] Circular 230, sec. 10.8(a) and (c). In addition, if an individual who is subject to sanction under Circular 230 acts on behalf of an employer, firm, or other entity, that employer, firm, or other entity is subject to sanction if it knew or reasonably should have known of actionable conduct. Circular 230, sec. 10.50(c)(1)(ii).

[612] Any individual who is not an attorney, CPA, enrolled agent, or registered tax return preparer who prepares (or assists in preparing) returns or refund claims or any documents pertaining to any person's tax liability for submission to the IRS (or substantially all of the returns or claims, or a substantial portion of a document) for compensation is subject to Circular 230 rules and sanctions. Accordingly, even though such an individual is not authorized to prepare returns for compensation, he or she becomes subject to Circular 230 rules by reason of preparing returns for compensation. Circular 230, sec. 10.8(a), (c). The IRS has determined that individuals who are not an attorneys, CPAs or enrolled agents may prepare and sign for compensation tax returns other than a Form 1040 without having to pass a competency exam or take continuing education. See Notice 2011-6, 2011-3 I.R.B. 315. These individuals may obtain a PTIN, sign the returns they prepare, and may represent the taxpayer before the IRS with respect to a return they signed. They may not represent themselves to the public or to the IRS as a registered tax return preparer or a Circular 230 practitioner but by preparing a tax return they become subject to Circular 230's rules and sanctions.

[613] See Notice 2011-6, 2011-3 I.R.B. 315; Circular 230, sec. 10.4(c).

continuing education courses,[614] to pass a compliance and suitability check,[615] and to possess a valid tax identification number ("PTIN") or other such number prescribed by the IRS in forms, instructions, or other guidance.[616] Since 2011, however, the D.C. District Court (and the D.C. Circuit affirming on appeal) has enjoined the Secretary of the Treasury from enforcing these regulations on the grounds that the Secretary's general authority to regulate practitioners is insufficient to permit regulation of return preparers who do not practice or represent taxpayers before an office of the Department of the Treasury.[617] These cases do not affect the requirement separately found under the Code and the regulations thereunder to possess a valid PTIN.[618]

Court Cases Related to Application of Circular 230 to Tax Return Preparers

In *Loving I,* a U.S. district court was asked to determine if under the Supreme Court's two-step analysis in Chevron,[619] the Department of the Treasury violated its statutory authority under Title 31 of the U.S. Code.[620] The Court held the general authority of the Secretary to regulate conduct before the Department of the Treasury was clear and could not be construed to include tax return preparation within its scope. The Court entered a preliminary injunction against enforcement of Circular 230 with respect to paid tax return preparers unless the paid tax return preparer is representing the taxpayer during an examination.

In *Loving II,* a U.S. Court of Appeals for the D.C. Circuit affirmed the judgment of the District Court after reviewing the decision de novo. The court rejected the IRS's argument that a paid tax return preparer is a "representative," citing the paid tax return preparer's lack of authority to legally bind the taxpayer. Additionally, the court rejected the IRS's argument that the meaning of "presenting a case" is irrelevant as scope of the statute is not so limited. The court ruled that the statute's granting of authority to regulate those that "practice… before the

[614] See Circular 230, sec. 10.6(f).

[615] See Circular 230, sec. 10.5(d). See also Circular 23, secs. 10.6 and 10.9 (requiring registered tax return preparers, enrolled agents, and enrolled retirement plan agents to take continuing education to satisfy renewal requirements).

[616] Circular 230, sec. 10.4(c).

[617] *Loving v. I.R.S.*, 917 F.Supp.2d 67 (D.D.C. 2013), (*Loving I)*, modified by *Loving v. I.R.S.*, 742 F.3d 1013 (D.C. Cir. 2014), (*Loving II*).

[618] Post *Loving I* and *Loving II*, preparers who were previously required to seek registered tax return preparer status are still required to obtain a PTIN under the authority of the section 6109 of the Code and can prepare returns and appear before the IRS in connection with returns they have prepared. See Notice 2011-6, 2011-3 I.R.B. 315.

[619] *Chevron U.S.A. Inc. v. Natural Res. Def. Council Inc.*, 467 U.S. 837 (1984).

[620] The first step of the *Chevron* analysis is to ask whether the intent of Congress is clear or ambiguous. If the intent of Congress is ambiguous, the reviewing court proceeds to the second step. The second step is to ask whether the agency's interpretation is a reasonable interpretation of the statute. *Loving I*, p. 8.

Department of the Treasury" could not be constructed to encompass the preparing and signing of tax returns, as such, "practice" only includes traditional adversarial proceedings.[621]

As a result of *Loving I* and *Loving II,* the IRS is enjoined from requiring attendance or collecting fees with respect to the testing and education programs, and imposing penalties for failure to participate. However, in *Brannen v. the United States,* the IRS's PTIN program along with the required user fee was ruled to be lawful, and remains in effect. On a yearly basis, all paid tax return preparers are required under this program to register with the IRS to obtain a PTIN. Additionally, the plaintiffs in *Loving I* and *II* did not object to the IRS further regulating paid tax return preparers that represent taxpayers during an examination, and the court explicitly excluded such paid tax return preparers from its judgment.

Description of Proposal

The proposal gives the Department of Treasury and the IRS explicit authority to regulate paid tax return preparers.[622]

Effective date.−The proposal is effective on or after the date of enactment.

Analysis

As the role of paid tax return preparers has increased, several groups charged with oversight, including the Government Accountability Office ("GAO") and the Treasury Inspector General for Tax Administration ("TIGTA") have identified errors and noncompliance related to the earned income tax credit (EITC) on returns prepared by unlicensed practitioners.[623] For its study, the GAO noted that its findings were consistent with the GAO's analysis of IRS's National Research Program database from tax years 2006 through 2009 which showed that tax returns prepared by preparers had a higher estimated percent of errors−60 percent−than self-prepared returns−50 percent.[624] Along similar lines, the National Taxpayer Advocate has

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[621] *Loving II*, p. 12.

[622] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.26, reprinted in the back of this volume.

[623] The Government Accountability Office ("GAO") and the Treasury Inspector General for Tax Administration ("TIGTA") have completed studies that analyzed the accuracy of returns prepared by unenrolled agents. In a study by GAO, two of the 19 tax returns prepared for the GAO showed the correct refund amount. Government Accountability Office, *In a Limited Study, Preparers Made Significant Errors* (GAO-14-467T), April 2014. In a study by TIGTA, 11 of the 28 tax returns prepared for TIGTA showed the correct refund amount. Inspector General for Tax Administration, Department of the Treasury, *Most Tax Returns Prepared by a Limited Sample of Unenrolled Preparers Contained Significant Errors* (TIGTA 2008-40-171), September 2008. GAO conducted an earlier study in 2006 that yielded similar results. Government Accountability Office, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors* (GAO-06-563T), April 4, 2006.

[624] In addition, in a 2002 report, the GAO found that as many as 1.1 million taxpayers who used the services of a paid preparer are likely to have overpaid their taxes because they took the standard deduction instead of

previously estimated that paid taxpayer return preparers are responsible for one third of mathematical errors related to the Earned Income Tax Credit.[625]

Those who support new regulation of paid tax return preparers by the Treasury and IRS argue that errors by tax return preparers can be minimized by issuing appropriate standards.[626] They argue that anyone is permitted to prepare a return for compensation, regardless of competence or adherence to ethical or professional standards. In addition, the oversight of tax return preparers is inconsistent because it is based on a number of considerations, such as whether the preparer is enrolled or unenrolled to practice before the IRS, whether the preparer is a CPA or an attorney, whether the preparer chooses to file electronically, and the jurisdiction in which the preparer practices.[627]

Supporters of the proposal may also point to Oregon's experience with its regulatory regime, in which paid preparers are required to complete qualifying education courses, pass a state-administered examination, and register to be certified as a licensed tax preparer. In addition, preparers must complete 30 hours of continuing education and re-register in each subsequent year. Supporters likely would cite findings that these regulations may have led to more accurate federal tax returns in that State. [628]

Supporters of the proposal may further point to the GAO's study that current oversight of paid tax return preparers has been challenging.[629] For example, the IRS has named return preparer fraud as one of its Dirty Dozen Tax Scams,[630] and has investigated paid tax preparers'

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itemizing deductions. Government Accountability Office, *Tax Deductions: Further Estimates of Taxpayers Who May Have Overpaid Federal Taxes by Not Itemizing* (GAO-02-509), March 29, 2002.

[625] National Taxpayer Advocate, *FY 2002 Annual Report to Congress* (23655L), December 2002.

[626] IRS Publication 4832, *Return Preparer Review*, December 2009, p. 18; Senate Committee on Finance Report to Accompany S.1321, the "Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act of 2006," S. Rept. No. 109-336, September 15, 2006, p. 8 ("the Committee believes that the IRS's failure to provide more oversight over such tax return preparers contributes to noncompliance. The Committee also believes that tax return preparer regulation will improve the accuracy of tax return preparation and, therefore, will reduce government burden and intrusion on taxpayers through IRS enforcement efforts (such as collection and examinations").

[627] See National Taxpayer Advocate, *FY 2002 Annual Report to Congress* (23655L), December 2002.

[628] Government Accountability Office, *Tax Preparers: Oregon's Regulatory Regime May Lead to Improved Federal Tax Return Accuracy and Provides a Possible Model for National Regulation* (GAO-08-781), August 15, 2008.

[629] Government Accountability Office, *Tax Administration, Most Taxpayers Believe They Benefit from Paid Tax Preparers, but Oversight for IRS is a Challenge* (GAO-04-70), October 2003.

[630] Department of Justice, *Justice Department Highlights Ongoing Efforts to Protect the Public and Shut Down Fraudulent Tax Return Preparers and Promoters Nationwide*, February 2014, available at http://www.justice.gov/opa/pr/2014/February/14-tax-145.html.

criminal activity; and referred such criminal activity to the Department of Justice.[631] Due to resource limitations, however, the IRS Criminal Investigation Division is currently able to identify and investigate only the most egregious cases of paid return preparer fraud.[632]

On the other hand, opponents of regulation question whether the regulatory burden placed on return preparers by any particular regulatory scheme outweighs the potential benefits of such regulations.[633] They express concern that some paid tax return preparers will be forced to either raise their prices or close their businesses due to the burden of complying with regulations and that these effects will be most keenly felt by tax return preparers serving low-income clients.[634]

25. Rationalize tax return filing due dates so they are staggered

Present Law

Persons required to file income tax returns[635] must file such returns in the manner prescribed by the Secretary, in compliance with due dates established in the Code, if any, or by regulations. The Code includes a general rule that requires income tax returns to be filed on or before the 15th day of the fourth month following the end of the taxable year, but certain exceptions are provided both in the Code and in regulations.

A partnership generally is required to file a Federal income tax return on or before the 15th day of the fourth month after the end of the partnership taxable year.[636] For a partnership with a taxable year that is a calendar year, for example, the partnership return due date (and the date by which Schedules K-1 must be furnished to partners) is April 15. However, a partnership

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[631] Internal Revenue Service, *How to Choose a Tax Preparer and Avoid Preparer Fraud*, January 2010, available at http://www.irs.gov/uac/Newsroom/How-to-Choose-a-Tax-Return-Preparer-and-Avoid-Preparer-Fraud-2010.

[632] For example, in 2009, the IRS Criminal Investigation Division only initiated 224 investigations. Internal Revenue Service, *How to Choose a Tax Return Preparer and Avoid Preparer Fraud*, available at http://www.irs.gov/uac/Newsroom/How-to-Choose-a-Tax-Return-Preparer-and-Avoid-Preparer-Fraud-2010.

[633] American Institute of Certified Public Accountants ("AICPA"), "Regulation of Tax Return Preparers," 2011, p.12, available at https://www.aicpa.org/InterestAreas/Tax/Resources/IRSPracticeProcedure/DownloadableDocuments/PTIN_article_final.pdf (AICPA questions whether the cost will result in raising the competency and professional standards of unlicensed preparers).

[634] In *Loving*, one of the plaintiffs argued that she would have to increase prices and would likely lose customers. The other two plaintiffs asserted that they would likely be forced to stop preparing tax returns. *Loving v. IRS*, 917 F.Supp.2d 67 (D.D.C. 2013), ("Loving I"), modified by *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014), ("Loving II").

[635] Section 6012 provides general rules identifying who must file an income tax return, while other Code provisions referenced herein specifically address filing requirements of partnerships, corporations, and other entities.

[636] Secs. 6031, 6072.

is allowed an automatic five-month extension of time to file the partnership return and the Schedules K-1 (to September 15 in the foregoing example) by submitting an application on Form 7004 in accordance with the rules prescribed by the Treasury regulations.[637]

A C corporation or an S corporation generally is required to file a Federal income tax return on or before the 15th day of the third month following the close of the corporation's taxable year. For a corporation with a taxable year that is a calendar year, for example, the corporate return due date is March 15.[638] However, a corporation is allowed an automatic six-month extension of time to file the corporate return (to September 15 in the foregoing example) by submitting an application on Form 7004 in accordance with the rules prescribed by the Treasury regulations.[639]

To assist taxpayers in preparing their income tax returns and to help the Internal Revenue Service ("IRS") determine whether such income tax returns are correct and complete, present law imposes a variety of information reporting requirements on participants in certain transactions.[640] The primary provision governing information reporting by payors requires an information return by every person engaged in a trade or business who makes payments aggregating $600 or more in any taxable year to a single payee in the course of the payor's trade or business.[641] Payments subject to reporting include fixed or determinable income or compensation, but do not include payments for goods or certain enumerated types of payments

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[637] Sec. 6081. Treas. Reg. sec. 1.6081-2. See Department of the Treasury, Internal Revenue Service, *2011 Instructions for Form 1065, U.S. Return of Partnership Income*, p. 3. Unlike other partnerships, an electing large partnership is required to furnish a Schedule K-1 to each partner by the first March 15 following the close of the partnership's taxable year (sec. 6031(b)). For calendar year 2012 partnerships, for example, the due date is March 15, 2013 even though the partnership return due date is April 15, 2013. However, an electing large partnership is allowed an automatic six-month extension of time to file the partnership return and the Schedule K-1s by submitting an application on form 7004 in accordance with the rules prescribed by the Treasury Regulations. Treas. Reg. sec. 1.6081-2(a)(2).

[638] Secs. 6012, 6037, 6072. Section 6012(a)(2) provides that every corporation subject to taxation under subtitle A shall be required to file an income tax return. Section 6037, which governs the returns of S corporations, provides that any return filed pursuant to section 6037 shall, for purposes of chapter 66 (relating to limitations) be treated as a return filed by the corporation under section 6012. Section 6072, which sets forth the due dates for filing various income tax returns, provides that returns of corporations with a taxable year that is a calendar year under section 6012 (and section 6037 based on the language in that section) are due March 15.

[639] Section 6081(b) provides that a corporation is allowed an automatic extension of three months to file its income tax return if the corporation files the form prescribed by the Secretary and pays on or before the due date prescribed for payment, the amount properly estimated as its tax. However, section 6081(a) provides that the Secretary may grant an automatic extension of up to six months to file and the Treasury regulations do so provide. Treas. Reg. sec. 1.6081-3.

[640] Secs. 6031 through 6060.

[641] Sec. 6041(a). The information return generally is submitted electronically as a Form-1099 or Form-1096, although certain payments to beneficiaries or employees may require use of Forms W-3 or W-2, respectively. Treas. Reg. sec. 1.6041-1(a)(2).

that are subject to other specific reporting requirements.[642] Detailed rules are provided for the reporting of various types of investment income, including interest, dividends, and gross proceeds from brokered transactions (such as a sale of stock) paid to U.S. persons.[643]

The payor of amounts described above is required to provide the recipient of the payment with an annual statement showing the aggregate payments made and contact information for the payor.[644] The statement must be supplied to taxpayers by the payors by January 31 of the year following the calendar year for which the return must be filed. Payors generally must file the information return with the IRS on or before the last day of February of the year following the calendar year for which the return must be filed,[645] unless they file electronically, in which event the information returns are due March 31.[646]

Payors also must report wage amounts paid to employees on information returns. For wages paid to, and taxes withheld from, employees, the payors must file an information return with the Social Security Administration ("SSA") by February 28 of the year following the calendar year for which the return must be filed.[647] However, the due date for information returns that are filed electronically is March 31.

Under the combined annual wage reporting ("CAWR") system, the SSA and the IRS have an agreement, in the form of a Memorandum of Understanding, to share wage data and to resolve, or reconcile, the differences in the wages reported to them. Employers submit Forms W-2, Wage and Tax Statement (listing Social Security wages earned by individual employees), and W-3, Transmittal of Wage and Tax Statements (providing an aggregate summary of wages paid and taxes withheld) directly to SSA.[648] After it records the Forms W-2 and W-3 wage

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[642] Sec. 6041(a) requires reporting as to fixed or determinable gains, profits, and income (other than payments to which section 6042(a)(1), 6044(a)(1), 6047(c), 6049(a), or 6050N(a) applies and other than payments with respect to which a statement is required under authority of section 6042(a), 6044(a)(2) or 6045). These payments excepted from section 6041(a) include most interest, royalties, and dividends.

[643] Secs. 6042 (dividends), 6045 (broker reporting) and 6049 (interest) and the Treasury regulations thereunder.

[644] Sec. 6041(d).

[645] Treas. Reg. sec. 31.6071(a)-1(a)(3)(i).

[646] Secs. 6011(e) and 6071(b) apply to "returns made under subparts B and C of part III of this subchapter"; Treas. Reg. sec. 301.6011-2(b), mandates use of magnetic media by persons filing information returns identified in the regulation or subsequent or contemporaneous revenue procedures and permits use of magnetic media for all others.

[647] Treas. Reg. sec. 31.6051-2; IRS, "Filing Information Returns Electronically," Pub. 3609 (Rev. 12-2011); Treas. Reg. sec. 31.6071(a)-1(a)(3)(i).

[648] Pub. L. No. 94-202, sec. 232, 89 Stat. 1135 (1976) (effective with respect to statements reporting income received after 1977).

information in its individual Social Security wage account records, SSA forwards the Forms W-2 and W-3 information to IRS.[649]

Description of Proposal

The proposal accelerates the due date for filing of Federal income tax returns of partnerships to conform to the due date for Federal income tax returns of S corporations, and removes C corporations from the scope of the exception to the general rule that requires income tax returns to be filed by the 15th day of the fourth month after the end of a taxable year.[650]

Under the proposal, both partnership and S corporation returns must be filed on or before the 15th day of the third month following the close of the taxpayer's taxable year, or March 15 in the case of a calendar year taxpayer. The proposal requires that C corporation returns be filed on or before the 15th day of the fourth month after the close of a taxable year, or April 15 in the case of a calendar year taxpayer.

The proposal also accelerates the filing date for all information returns except forms 1099-B to January 31, and eliminates the extended due date for electronically filed returns. The due date for payee statements remains the same.

Effective date.−The proposal is generally effective for returns required to be filed after December 31, 2014.

Analysis

The order in which various income tax returns and information returns are due has been identified as a problem that undermines tax compliance. The proposal addresses two different problems presented by the due dates: First, the sequence of information provided to taxpayers complicates return preparation and second, the limitations on access to information returns by the IRS during the processing of income tax returns to which those information returns relate.

Sequence of return filing dates

The sequence of return filing dates complicates a taxpayer's ability to prepare an accurate return, because the information that a taxpayer is required to assemble with respect to all income-generating investments or activities may not be available until shortly before, after or contemporaneous with one's filing date. The filing due date for flow-through entities such as S corporations and partnerships is April 15 for calendar year taxpayers, and thus falls after the filing due date for corporations owning an interest in such entities and before the due date for individual owners. The sequence of due dates thus necessitates reliance on extensions of due

[649] Employers submit quarterly reports to IRS on Form 941 regarding aggregate quarterly totals of wages paid and taxes due. IRS then compares the W-3 wage totals to the Form 941 wage totals.

[650] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.27, reprinted in the back of this volume.

dates for filing. Receipt of information shortly before the income tax due date may contribute to errors on original returns that later require amendment. Reordering the due dates for filing income tax returns so that both partnerships and S corporations file before C corporations and individuals may reduce the need for routine use of extensions. The American Institute of Certified Public Accountants ("AICPA") has supported efforts to rationalize the flow of information to taxpayers and their preparers, pointing to improved efficiency in the preparation of returns, possible reduction in the number of amended returns to be filed, and avoidance of a compressed work schedule for CPAs working on end of year matters and return preparation.[651]

Critics of the proposal may note that the availability of extensions will remain attractive to persons with complex returns or those who are inclined to be dilatory. To the extent that the extensions continue to be widely used by partnerships, the investors in such partnerships will remain unable to complete return preparation and likely request extension of time to file. Therefore, any changes in the sequencing of due dates should be accompanied by changes to the periods for which extensions are permitted as well, to assure that the desired rational sequence of information is achieved.

IRS access to information returns during filing season

The second aspect of the proposal changes the due date for information returns for wages and retirement payments. This change is not designed to alter the ability of taxpayers to prepare their returns based on these information returns, but instead is intended to assist the IRS in efficient processing of returns and detection of errors through verification by improving the likelihood that the IRS will have access to the data contained in information returns received during the filing season.[652] Such access is critical in deterring fraudulent claims for refund, especially claims by identity thieves.

Proponents note that the gap between the time that information reports by payors are required to be provided to individuals (generally, no later than January 31 following the close of the calendar year[653]), and the time that the payor is required to submit the related information return to the IRS is unnecessarily long. The present law disparity between the due date for submitting information returns on paper and filing electronically may contribute to the problem. Although paper returns take longer to process than those that are electronically submitted, that does not support delaying the electronic filing due date. Rather, it may suggest that greater measures to encourage electronic filing are advisable.

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[651] See, "AICPA Recommends Change to Return Due Dates," available at http://www.aicpa.org/InterestAreas/Tax/Resources/TaxLegislationPolicy/Pages/duedatesproposal2010.aspx.

[652] The individual income tax filing season is the period beginning in January when the IRS first accepts for filing income tax returns for the preceding calendar year and ending April 15, the due date (absent an extension) for individual income tax returns. In 2014, the filing season opened January 31, 2014, according to a news release issued December 18, 2013. See IR-2013-100, available at www.irs.gov/newsroom.

[653] Sec. 6051.

The most significant information report with respect to identifying fraudulent refund claims may be the information reports on wages paid to, and taxes withheld from, employees. That information is compiled by each employer in Form W-3, with copies of all Forms W-2 attached, and submitted directly to the Social Security Administration.[654] The information on the Forms W-3 is not available to the IRS until it has been processed by Social Security Administration, which may not be completed during the filing season. As a result, third-party reporting is limited as a tool to identify and reject fraudulent claims.

The IRS Commissioner testified before the Financial Services and General Government Subcommittee of the Senate Committee on Appropriations about the importance of earlier access to wage reporting information in order to combat identity theft and detect fraudulent refund claims.[655] With many Forms W-3 not submitted until late March, and individuals increasingly using electronic filing earlier in the season, the IRS is without an opportunity to detect many fraudulent refunds before they are paid.

Opponents of the proposal to require earlier filing dates for information returns may point to the need for a reasonable period of time between submission of information to a payee and filing with a government agency, during which the payee may identify errors and inform the payor.

26. Increase the penalty applicable to paid tax preparers who engage in willful or reckless conduct

Present Law

Tax return preparers are subject to a penalty for preparation of a return or refund claim with respect to which an understatement of tax liability results. If the understatement is due to an "unreasonable position," the penalty is the greater of $1,000 or 50 percent of the income derived (or to be derived) by the return preparer with respect to that return.[656] Any position that a return preparer does not reasonably believe is more likely than not to be sustained on its merits is an "unreasonable position" unless the position is disclosed on the return or there is "substantial authority" for the position.[657] There is a substantial authority for a position if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. If the position taken meets the definition of a tax shelter (as defined in section 6662(d)(2)(B)(ii)(I)) or a listed or reportable transaction (as referenced in 6662A), the preparer must have a reasonable belief that the position would more likely than not be sustained on its merits. If the understatement is due to willful or reckless conduct, the penalty

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[654] Treas. Reg. sec. 31.6051-2; IRS, "Filing Information Returns Electronically," Pub. 3609 (Rev. 12-2011); Treas. Reg. sec. 31.6071(a)-1(a)(3)(i).

[655] Hoffman, WIlliam, "Koskinnen Asks Senate to Approve Access to Information Earlier," *Tax Analysts* Doc. 2014-10721.

[656] Sec. 6694(a)(1).

[657] Sec. 6694(a)(2).

increases to the greater of $5,000 or 50 percent of the income derived (or to be derived) by the return preparer with respect to that return.[658]

Description of Proposal

The proposal increases the penalty rate on paid tax return preparers for understatements due to willful or reckless conduct to the greater of $5,000 or 75 percent of the income derived (or to be derived) by the preparer with respect to the return or claim for refund.[659]

Effective date.−The proposal is effective for returns required to be filed after December 31, 2014.

Analysis

Proponents may argue that the present-law penalty formula results in the same amount (because 50 percent of the income derived by the preparer is greater than the fixed dollar penalties that may be imposed) regardless of whether the preparer's conduct was willful and reckless and, therefore, is an inadequate deterrent to noncompliance. Increasing the dollar amount of these penalties increases the expected costs of noncompliant behavior and, thus, could be expected to deter willful or reckless conduct. Proponents also may argue that it is appropriate to assess the amount of the penalty by reference to a larger percentage of the preparer's fee, which represents the best measure of the preparer's stake in the taxpayer's return. On the other hand, opponents may argue that the imposition of a penalty on 75 percent of the preparer's fee will lead to anomalous results in situations in which the amount of the penalty exceeds the amount of tax in question.

27. Enhance administrability of the appraiser penalty

Present Law

Valuation misstatements may result in penalties against the taxpayer who reports the valuation misstatement on a Federal tax return, the person who prepares the valuation appraisal on which the misstatement is based and a paid return preparer who prepares a return reporting a position based on the misstatement, resulting in an underpayment.

A person who prepares an appraisal that he or she knows (or should know) will be used to support a tax position on a return or claim for refund is subject to a civil penalty if such appraisal results in a substantial or gross valuation misstatement within the meaning of the

[658] Sec. 6694(b).

[659] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.28, reprinted in the back of this volume.

accuracy-related penalty provisions.[660] The penalty is equal to the greater of $1,000 or 10 percent of the understatement of tax resulting from a substantial or gross valuation misstatement, up to a maximum of 125 percent of the gross income derived from the appraisal, and may be assessed without opportunity for pre-payment judicial review, unlike the accuracy-related penalties. The statute provides an exception if the appraiser establishes that it was "more likely than not" that the appraisal value was the proper value.

The concept of substantial or gross valuation misstatement is based on the accuracy-related penalties provisions that may be asserted against taxpayers for underpayments of tax that are due to a substantial or gross valuation misstatement or to substantial or gross estate or gift tax valuation understatements.[661] The amount of the accuracy-related penalty depends upon the degree of error in the valuation. For income tax purposes, a substantial valuation misstatement exists if the claimed value of any property is 150 percent or more of the amount determined to be the correct value, and results in a penalty in the amount of 20 percent of the portion of underpayment attributable to the substantial valuation misstatement. If the underpayment is attributable to an overstated property value that is 200 percent or more of the amount determined to be the correct value, the valuation is a gross valuation misstatement and the accuracy-related penalty is doubled to 40 percent. A substantial estate or gift tax valuation misstatement exists when the claimed value of any property is 65 percent or less of the amount determined to be the correct value. A gross misstatement of estate or gift tax valuation exists when the claimed value of any property is 40 percent or less of the amount determined to be the correct value. Taxpayers who satisfy the reasonable cause exceptions may avoid the accuracy-related penalty.[662]

Tax return preparers also are subject to a penalty for preparation of a return or refund claim with respect to which an understatement of tax liability results. If the understatement is due to an "unreasonable position," the penalty is the greater of $1,000 or 50 percent of the income derived by the return preparer with respect to that return.[663] Any position that a return preparer does not reasonably believe is more likely than not to be sustained on its merits is an "unreasonable position" unless the position is disclosed on the return or there is "substantial authority" for the position.[664] There is substantial authority for a position if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities

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[660] Sec. 6695A; In Notice 2006-96, 2006-2 C.B. 902, IRS provided preliminary guidance on application of the penalty, pending issuance of final regulations implementing the appraisal standards under section 170(f), enacted at the same time as section 6695A.

[661] Sec. 6662.

[662] Under section 6664, reasonable cause is a defense for most accuracy-related penalties, with two exceptions. Reasonable cause is not a defense if the underpayment is attributable to an overstatement of value of a charitable deduction property, unless the appraisal and person providing the appraisal meet the standards of section 170(f)(11)(E). See Treas. Reg. sec. 1.170A-13(c)(3). In addition, the reasonable cause defense is not available if the underpayment is attributable to a transaction that lacks economic substance within the meaning of section 7701(o) or similar rule of law.

[663] Sec. 6694(a)(1).

[664] Sec. 6694(a)(2).

supporting contrary treatment. If the position taken meets the definition of a tax shelter (as defined in section 6662(d)(2)(B)(ii)(I)) or a listed or reportable transaction (as referenced in section 6662A), the preparer must have a reasonable belief that the position would more likely than not be sustained on its merits. If the understatement is due to willful or reckless conduct, the penalty increases to the greater of $5,000 or 50 percent of the income derived by the return preparer with respect to that return.[665] In certain instances, a return preparer may also prepare an appraisal on which a return position is based, and is therefore subject to both the preparer penalty and the appraiser penalty.

Description of Proposal

The proposal makes two changes to the assessable penalty under section 6695A for the preparation of an appraisal that results in a substantial or gross valuation misstatement on a return or claim for refund.[666] First, the standard of care required of an appraiser in order to establish a defense against assertion of the penalty is changed to reasonable cause for the valuation provided. Second, the proposal includes an anti-stacking rule, barring imposition of both the return preparer penalty under section 6694 for understatement of a taxpayer's liability and the appraiser penalty under section 6695A with respect to the same appraisal.

Effective date.−The proposal is effective for returns required to be filed after December 31, 2014.

Analysis

The Administration provides separate rationales for each of the two proposed changes. According to the rationale for the change in standard of care, there is a need to provide a reasonableness standard for appraisers because they are likely to be unfamiliar with the concept of quantifying the likely correctness of a valuation, as required by the "more likely than not" standard. The Administration proposes an anti-stacking rule to address concerns about duplicative penalties with respect to the same appraisal due to the applicability of both preparer and appraiser penalties under sections 6694 and 6695A, respectively. There is little information available to determine the empirical basis for either rationale. Anecdotal information suggests that the appraiser penalty is imposed infrequently, compared to the more widely used preparer penalty, although referrals to the Office of Professional Responsibility ("OPR") concerning appraisals are rising.[667]

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[665] Sec. 6694(b).

[666] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVII.C.29, reprinted in the back of this volume.

[667] In August 2011, the Standards of Practice before the IRS were revised to add appraisers to the persons who are subject to oversight of the OPR. For a full discussion of OPR exercise of jurisdiction over appraisal activities, see Michael Gregory, "IRS Oversight of CPAs Who Provide Valuation Services," Journal of Accountancy, December 2013, available at www.journalofaccountancy.com/issues/2013/dec/20138779.

Appraisers whose valuations result in misstatements that are sufficiently substantial to support a penalty and are also not familiar with the concept of "more likely than not" are difficult to identify. The appraisals that first led to enactment of the penalty were conservation easements evaluated for purposes of supporting a charitable contribution.[668] The standards concerning evaluations were extended to business evaluations for estate tax purposes, often prepared by persons also responsible for the estate tax return.[669] In both cases, it is likely that the appraiser knows the tax-motivated purpose leading to the request for an appraisal, making it likely that the standard the requester needed to satisfy was known to the appraiser. To the extent that there are persons subject to both penalties, such persons are currently operating under the standard of "more likely than not" for both aspects of practice, and changing the appraiser penalty will introduce disparity rather than conformity.

The IRS has instructed agents to consider the appraiser penalty in appropriate cases, together with referral to the OPR if the appraiser is subject to oversight by that office.[670] The infrequency of use of the appraiser penalty may suggest that the IRS exercises discretion to avoid duplicative penalties if the individual in question is also subject to the more frequently used preparer penalty. On the other hand, it may suggest that the standards for appraisers required in the charitable contribution area are gaining broad acceptance and reducing the instances of appraisal issues, especially in light of widely publicized cases, such as the settlement between the IRS and appraisers involved in substantial misstatement valuations of conservation easements.[671]

[668] A discussion of the concerns about conservation easements that lead to enactment of appraisal standards and the related penalty is included at pages 277-292 of Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures,* January 27, 2005, JCS-02-05.

[669] CPAs may get certified in business valuation, or satisfy the AICPA standards [Statement on Standards for Valuation Services No. 1, "Valuation of a Business, Business Ownership Interest, Security or Intangible Asset," ("SSVS1")] which the IRS recognizes as generally accepted business appraisal standards.

[670] IRM par. 20.1.12.3 now requires that an examining agent refer a case to OPR if the examining agent believes that the valuation misstatement is willful.

[671] See, IRS press release announcing a settlement by OPR and appraisers who prepared easement valuations, under which the appraisers are barred from practice for five years. IR-2014-31, March 19, 2014.

PART XVIII – SIMPLIFY THE TAX SYSTEM

A. Simplify the Rules for Claiming the Earned Income Tax Credit for Workers Without Qualifying Children

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 657-660. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVIII.A, reprinted in the back of this volume.

B. Modify Adoption Credit to Allow Tribal Determination of Special Needs

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 186-187. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVIII.B, reprinted in the back of this volume.

C. Simplify Minimum Required Distribution (MRD) Rule

Description of Modifications

Present Law

Individual retirement arrangements

There are two basic types of individual retirement arrangements ("IRAs") under present law: traditional IRAs,[672] to which both deductible and nondeductible contributions may be made,[673] and Roth IRAs, to which only nondeductible contributions may be made.[674] An annual limit applies to contributions to IRAs. The contribution limit is coordinated so that the aggregate maximum amount that can be contributed to all of an individual's IRAs (both traditional and Roth) for a taxable year is the lesser of a certain dollar amount ($5,500 for 2014 and 2015) or the individual's compensation, plus, for individuals at least age 50, an additional $1,000 catch-up

[672] Sec. 408.

[673] Sec. 219 and 408(o).

[674] Sec. 408A. Only individuals with adjusted gross income ("AGI") below certain levels may make nondeductible contributions to a Roth IRA but, as discussed below, a taxpayer is able to do a Roth conversion with respect to amounts held in a traditional IRA, including amounts attributable to nondeductible contributions. This may effectively allow individuals with AGI above the limits to make nondeductible contributions to a Roth IRA.

contribution amount.[675] In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount.

The principal difference between traditional and Roth IRAs is the timing of income tax inclusion. For a traditional IRA, an eligible contributor may deduct the contributions made for the year.[676] Nondeductible contributions are also permitted. Distributions from traditional IRAs are includible in gross income to the extent attributable to earnings on the account and the deductible contributions.[677] For a Roth IRA, all contributions are nondeductible, but qualified distributions are not includible in gross income. A qualified distribution from a Roth IRA is a distribution that both (1) is made after the five-taxable-year period beginning with the first taxable year for which the individual first made a contribution to a Roth IRA, and (2) is made after the individual attains age 59½, dies, or becomes disabled, or is made for first-time homebuyer expenses of up to $10,000.

In the case of distributions from traditional IRAs and nonqualified distributions from Roth IRAs, nondeductible contributions are recovered tax-free as basis. For recovery of basis, all IRAs of the same type (traditional or Roth) are combined and treated as a single account in determining the amount of any distribution that is a return of basis. In the case of traditional IRAs, the portion (if any) of a distribution that is a tax-free return of basis is the portion that bears the same ratio to the total distribution amount as the combined unrecovered basis in all of an individual's traditional IRAs bears to the combined total account balances of the individual's traditional IRAs (called "pro rata basis recovery"). In the case of nonqualified distributions from Roth IRAs, the entire amount of an individual's basis in all Roth IRAs is recovered before any portion of any nonqualified distribution from a Roth IRA is taxable as a distribution of earnings.

The rules for the two types of IRAs differ in other respects. An individual who has attained age 70½ prior to the close of a year is not permitted to make contributions to a traditional IRA. In contrast, contributions to a Roth IRA may be made even after the account owner has attained age 70½. Further, traditional IRAs are subject to the lifetime and after-death minimum required distribution rules, generally requiring distributions to begin at 70½; Roth

[675] The regular dollar limit is indexed to reflect cost-of-living increases but the catch-up contribution limit is not indexed.

[676] If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with AGI for the taxable year over certain indexed levels. No AGI limitation applies to nondeductible contributions to a traditional IRA.

[677] Section 72(t) imposes an early distribution tax on distributions made from certain tax-favored retirement plans before an employee or an IRA owner attains age 59½. The tax is equal to 10 percent of the amount of the distribution that is includible in gross income unless an exception applies. The 10-percent tax is in addition to the taxes that would otherwise be due on distribution.

IRAs are subject only to the after-death and not to the lifetime minimum required distribution rules.[678]

Section 401(k) plans, section 403(b) plans, and governmental section 457(b) plans

A qualified retirement plan that is a profit-sharing plan or stock bonus plan (and certain money purchase pension plans) may allow an employee to make an election between cash and an employer contribution to the plan pursuant to a qualified cash or deferred arrangement.[679] A plan with this feature is generally referred to as a "section 401(k) plan." A "section 403(b) plan" may allow a similar salary reduction agreement under which an employee may make an election between cash and an employer contribution to the plan.[680]

Amounts contributed pursuant to these qualified cash or deferred arrangements and salary reduction agreements generally are referred to as elective deferrals. The elective deferrals generally are excludable from gross income (pretax elective deferrals) and taxed along with attributable earnings upon distribution from the plan. Alternatively the plan may include a qualified Roth contribution program under which eligible employees are offered a choice of either making pretax elective deferrals or making elective deferrals that are not excluded from income and are designated as Roth contributions.[681] Qualified distributions of designated Roth contributions and attributable earnings are excluded from gross income. A qualified distribution is a distribution that is made after both (1) an employee's completion of a specified 5-taxable year period that begins with the first taxable year in which an amount held in the designated Roth account under the plan was contributed and (2) the employee attains age 59½, dies, or becomes disabled. The aggregate amount of elective deferrals (both pretax elective deferrals and designated Roth contributions) that an employee is permitted to contribute to section 401(k) and section 403(b) plans for a taxable year is subject to a combined dollar limit ($17,500 for 2014 increased to $18,000 for 2015) plus, for employees at least age 50 an additional catch up amount ($5,500 for 2014 increased to $6,000 for 2015), or the participant's compensation, if less.[682]

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[678] The minimum required distribution rules are described in detail in the description of present law in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), "Eliminate Required Minimum Distribution Rules for Balances of $75,000 or Less," June 2012, p. 661. The lifetime minimum required distribution rules have been modified since June 2012 to provide special rules for qualifying longevity annuity contracts. See Treasury Decision 9673, 79 F.R. 37633 (July 2, 2014)

[679] Sec. 401(k).

[680] Section 403(b) provides for tax-favored retirement plans that may be maintained only by (1) tax-exempt charitable organizations, and (2) educational institutions of State or local governments (including public schools) ("section 403(b) plans"). Many of the rules that apply to section 403(b) plans are similar to the rules applicable to qualified retirement plans, including section 401(k) plans.

[681] Sec. 402A.

[682] In some cases additional elective contributions or other contributions may be made under a section 403(b) plan. The employer may also make nonelective and matching contributions for employees under a section 401(k) or 403(b) plan. These are not permitted to be designated as Roth contributions and generally are pretax contributions. Pursuant to section 415(c) and 403(b)(1), total contributions (including elective contributions) for an

A "governmental section 457(b) plan" may also provide for elective deferrals.[683] The same dollar limit applies to governmental section 457(b) plans ($17,500 for 2014 increased to $18,000 for 2015 plus an additional catch-up contribution limit ($5,500 for 2014 increased to $6,000 for 2015) for participants at least age 50, or the participant's compensation, if less),[684] except that there is no coordination with the limit on elective deferrals to section 401(k) and section 403(b) plans. A governmental section 457(b) plan may also include a qualified Roth contribution program.

Unlike Roth IRAs, designated Roth accounts are generally otherwise subject to the same rules as nonRoth accounts under an employer-sponsored plan but the rules for employer sponsored plans differ somewhat from the IRA rules. If an employee continues to work for an employer after age 70½, the employee is not denied the opportunity to make pretax elective deferrals or designated Roth contributions to an employer-sponsored plan merely because the individual has attained age 70½. Both pre-tax and designated Roth accounts under an employer-sponsored plan are subject to both the lifetime and after-death minimum required distribution rules. Thus, an employee is generally required to begin distributions from a designated Roth account at age 70½.[685] A section 401(k) or 403(b) plan may also provide for after-tax employee contributions that are not designated Roth contributions which are also permitted to be maintained in a separate account. Pro rata basis recovery applies to amounts distributed from the separate after-tax account, taking into account only the employee's after-tax contributions and the separate account balance. In the case of nonqualified distributions from a designated Roth account, basis for the after-tax Roth contributions is also recovered pro rata, taking into account only the employee's unrecovered designated Roth contributions and designated Roth account balance. However, a distribution from a designated Roth account generally is permitted to be contributed to a Roth IRA as a tax-free rollover (either by a direct trustee-to-trustee transfer or contribution to the Roth IRA within 60 days of the distribution), allowing a taxpayer to take advantage of the special rules for Roth IRAs.[686]

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employee to a section 401(k) plan or 403(b) plan for a plan year for an employee generally cannot exceed $52,000 for 2014 (or the employee's compensation, if less).

[683] Section 457(b) provides rules for an eligible deferred compensation plan. In the case of an eligible deferred compensation plan maintained by state of local government (or an agency or instrumentality thereof) , pursuant to section 457(g), the plan must be funded and the assets of the plan must be held in a trust for the exclusive benefit of plan participants and their beneficiaries ("governmental section 457(b) plan").

[684] Under a special rule, additional catch-up contributions may be made by a participant to a governmental section 457(b) for the last three years before attainment of normal retirement age.

[685] However, an employee (other than a five-percent owner) who continues working for the employer maintaining the plan past age 70½ is not required to begin distributions from an employer-sponsored retirement plan (including from a designated Roth account) until after retirement with the employer.

[686] Sec. 408(d)(3).

Roth conversions

Taxpayers generally may convert an amount in a traditional IRA into a Roth IRA.[687] The amount converted is includible in the taxpayer's income as if a withdrawal had been made, (except that the 10-percent early distribution tax does not apply) and the amount converted becomes part of the employee's basis in the individual's Roth IRAs.[688] The conversion is accomplished either by a trustee-to-trustee transfer of the amount from the traditional IRA to the Roth IRA, or by a distribution from the traditional IRA and contribution to the Roth IRA within 60 days. A distribution from an employer-sponsored tax-favored retirement plan that is not from a designated Roth account is also permitted to be rolled over into a Roth IRA, subject to the same income inclusion rules that apply to a conversions from a traditional IRA to a Roth IRA.[689]

A section 401(k) plan, a section 403(b) plan or a governmental section 457(b) plan that includes a qualified Roth contribution program is permitted to allow individuals to elect an in-plan transfer of any amount from an account that is not a designated Roth account under the plan to a designated Roth account maintained under the plan for the benefit of the individual. The transfer is allowed whether or not the amount is distributable. The transfer is a form of Roth conversion, and the amount transferred is subject to the income inclusion rules that apply to conversions from a traditional IRA into a Roth IRA and becomes part of the employee's basis in the designated Roth account.

Modification of proposal

The proposal is modified in two respects.[690] First, the modified proposal raises the threshold for being exempted from the minimum required distribution rules after a measurement date from $75,000 to $100,000. Second, the proposal makes two changes to the present law rules applicable to Roth IRAs. Under the modified proposal, (1) Roth IRAs are subject to the minimum required distribution rules that apply with respect to traditional IRAs during the

[687] Although an individual with AGI exceeding certain limits is not permitted to make a contribution directly to a Roth IRA, the individual can make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA.

[688] The early distribution tax is imposed if the taxpayer withdraws the amount within five years of the conversion.

[689] Rollovers to IRAs of distributions from tax-favored employer-sponsored plans (qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans) are also permitted. For tax-free rollovers, distributions from pretax accounts under an employer-sponsored plan must be contributed to a traditional IRA and distributions from a designated Roth account are only permitted to be contributed to a Roth IRA.

[690] The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), "Eliminate Required Minimum Distribution Rules for Balances of $75,000 or Less," June 2012, p. 661. The fiscal year 2014 budget proposal is identical to the fiscal year 2013 budget proposal. The title of the fiscal year 2015 budget proposal is changed to "Simplify Minimum Required Distribution (MRD) Rules." The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), Item XVIII.C, reprinted in the back of this volume.

lifetime of an IRA owner (requiring minimum distributions to commence April 1 after the IRA owner attains age 70½) as well as the rules that apply after the death of the IRA owner; and (2) contributions are not allowed to be made to a Roth IRA after the IRA owner attains age 70½.

Analysis

As indicated in the reasons for change provided in the modified proposal, the required minimum distribution rules are intended to assure that tax-favored retirement savings are used for retirement and are designed to prevent taxpayers from leaving these amounts to accumulate in tax-favored arrangement for the benefit of the taxpayer's heirs.[691] While no tax is due on qualified distributions from Roth accounts, Roth account holders continue to benefit from tax-free accumulations in an account. Although some argue that changing present law to apply the minimum required distribution rules to Roth IRAs during the IRA owner's life time and to preclude contributions to a Roth IRA after the IRA owner attains age 70½ does not make the required minimum distribution rules simpler, they recognize that continuing to provide these more favorable rules for Roth IRAs allows greater accumulation of tax-favored retirement savings within Roth IRAs than within traditional IRAs.

Even though contributions to Roth IRAs and designated Roth accounts ("Roth accounts") are made on an after-tax basis, the potential for tax-free distribution of earnings from Roth accounts causes retirement savings using Roth accounts generally to be economically equivalent to retirement savings in the same amount through deductible contributions to a traditional IRAs or pretax elective deferrals under employer-sponsored tax-favored retirement plans ("pretax accounts").[692] Further, the effect of contribution limits allows a greater amount of tax-favored

[691] This analysis of the proposal supplements the analysis in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), "Eliminate Required Minimum Distribution Rules for Balances of $75,000 or Less," June 2012, p. 661.

[692] The following examples illustrate the economic equivalence of saving the same amount through Roth accounts versus through pretax accounts. Assume that a taxpayer's marginal tax rate is 20 percent and the taxpayer saves $1,000 of his income using an IRA. In the case of a deductible contribution to a traditional IRA, the $1,000 of savings gives the taxpayer a $1,000 deduction and thereby reduces the taxpayer's tax liability by $200 (20 percent of $1,000). Assume that the taxpayer (over age 59½) withdraws the savings (plus interest) one year later. If the account yields a five percent rate of return, the taxpayer withdraws $1,050. The withdrawal is included in the tax base and is taxed at the 20-percent rate, for an additional tax liability of $210, leaving the taxpayer with net proceeds of $840. If instead, the taxpayer pays tax of $200 on the $1,000 set aside from current consumption, and contributes the remaining $800 to a Roth IRA, then, when the taxpayer withdraws $840 as a qualified distribution in the following year (the $800 put in the account plus a five-percent return), none of that amount is included in the tax base, and thus there is no tax liability. In both examples, the taxpayer earns a rate of return on deferred consumption equal to the full pretax rate of return on saving. Specifically, in both cases, the taxpayer trades $800 of first period consumption (or current compensation) for $840 in second period consumption (future consumption). The combination of a deduction for saving and inclusion of all proceeds in the base upon withdrawal from the pretax savings account has the same result as exempting from tax the return on saving. This result is an analog of the "Cary Brown theorem," which holds that, assuming constant tax rates, permitting an immediate deduction for the cost of a marginal asset that ordinarily would be purchased with after-tax dollars is equivalent to exempting the yield from the asset from tax. Cary Brown, "Business-Income Taxation and Investment Incentives," in Income, Employment and Public Policy: Essays in Honor of Alvin H. Hansen 300 (1948). See also Joint Committee on Taxation, "Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II," (JCX-63-07), September 4, 2007, page 6 for a related discussion.

retirement savings through Roth accounts than through pretax accounts.[693] Thus, there is no reason to provide more taxpayer-favorable rules for Roth IRAs than for traditional IRAs, and the resulting potential for greater tax-favored accumulations in Roth IRAs. In fact, some argue, allowing Roth contributions up to the same limits as pretax contributions by itself provides an opportunity for greater tax-favored accumulations in Roth IRAs than traditional IRAs.

Some suggest that the better way to coordinate the requirements for the two types of IRAs would be to allow contributions after age 70½ to traditional IRAs. Contributions to IRAs are limited not only by a dollar limit but also by the amount of the taxpayer's earned income (or the earned income of the taxpayer's spouse). They argue that, similar to the rules for contributions to an employer-sponsored tax-favored plan, contributions to either a traditional IRA or a Roth IRA should be allowed to continue as long as the taxpayer (or the taxpayer's spouse) is continuing to work (and thus has earned income). This may be particularly appropriate in the case of an IRA owner who is continuing to work and has tax-favored retirement saving at age 70½ in an amount less than the $100,000 threshold under the proposal for being exempt from the required minimum distribution rules.

Further, some question the appropriateness of requiring distributions to begin to an employee or IRA owner from any tax-favored retirement savings arrangement at age 70½, particularly if the individual is still working. They argue that age 70½ is too early for an individual to properly assess his or her income needs over his or her remaining lifetime, particularly because health costs may increase significantly at later ages. Others respond that the required minimum distribution rules do not require an individual to consume the amount required to be distributed but rather only require the individual to move the amount out of tax-favored retirement savings. Increasing the age for commencing required distributions increases the potential for leaving these amounts to accumulate in tax-favored arrangement for the benefit of an individual's heirs. Thus, some suggest that any decision to raise the age at which required minimum distributions must commence needs to be considered in the context of a review of the required minimum distribution rules that apply after the death of an employee or IRA owner. Further, others suggest that raising the age for commencement may not be appropriate for

[693] The economic equivalence of saving in a Roth account or a pretax account does not mean that a dollar contributed to a Roth account is the economic equivalent of a dollar contributed to a pretax account. A dollar that is contributed to a Roth IRA or designated Roth account represents an after-tax contribution, and therefore requires a greater reduction in current consumption (since the contribution is not deductible). As a result, an after-tax contribution to a Roth account represents more saving than the same contribution to a pretax account. As the above examples show, a taxpayer in the 20-percent tax bracket must reduce current consumption by $1,000 to contribute $1,000 to a Roth account, but only by $800 to contribute $1,000 to a pretax account, because the $1,000 contribution reduces current tax liability by 20 percent of $1,000, or $200. For taxpayers not constrained by a limit on retirement savings, the proper economic comparison of the tax benefits of the two types of tax-favored saving for a taxpayer with a 20-percent marginal rate is the comparison of an 80 cent Roth retirement savings contribution for each dollar contribution of pretax retirement savings because each requires the same reduction in current consumption. The equivalence is easily seen mathematically: the final after-tax value of the contribution to the deductible IRA is given by $C * (1+r)^n * (1-t)$, where C equals the contribution, r the annual rate of return, n the number of years the investment is held, and t the tax rate. The final after-tax value of the equivalent Roth IRA contribution is $(1-t) * C * (1+r)^n$. Note that $(1-t) * C$ represents the reduced amount that can be contributed to the Roth IRA since tax must be paid first. The expressions are mathematically equivalent when t is unchanged.

employees and IRA owners with aggregate retirement savings above the level needed to provide them with financial security during retirement.

Some suggest that the coordination in the proposal does not go far enough to make the rules for Roth IRAs and traditional IRAs the same. They suggest that the same pro rata recovery of basis that applies to distributions from traditional IRAs (and for basis recovery from employer-sponsored retirement plans, including from designated Roth accounts) should apply to nonqualified distributions from Roth IRAs. Allowing all distributions from Roth IRA to be tax-free, including not being subject to the 10-percent early distribution tax, until all the IRA owner's basis in the account is recovered may encourage early withdrawals from Roth IRAs.

D. Allow All Inherited Plan and Individual Retirement Account or Annuity (IRA) Balances to be Rolled Over Within 60 Days

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 673-677. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVIII.D, reprinted in the back of this volume.

E. Repeal Non-Qualified Preferred Stock Designation

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 683-692. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVIII.E, reprinted in the back of this volume.

F. Repeal Preferential Dividend Rule for Publicly Traded and Publicly Offered Real Estate Investment Trusts

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 693-698. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVIII.F, reprinted in the back of this volume.

G. Reform Excise Tax Based on Investment Income of Private Foundations

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget*

Proposal (JCS-2-12), June 2012, pp. 699-703. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVIII.G, reprinted in the back of this volume.

H. Remove Bonding Requirements for Certain Taxpayers Subject to Federal Excise Taxes on Distilled Spirits, Wine, and Beer

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 704-706. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVIII.H, reprinted in the back of this volume.

I. Simplify Arbitrage Investment Restrictions

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 707-710. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVIII.I, reprinted in the back of this volume.

J. Simplify Single-Family Housing Mortgage Bond Targeting Requirements

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 710-713. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVIII.J, reprinted in the back of this volume.

K. Streamline Private Business Limits on Governmental Bonds

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 713-716. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVIII.K, reprinted in the back of this volume.

L. Exclude Self-Constructed Assets of Small Taxpayers form the Uniform Capitalization (UNICAP) Rules

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 188-189. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVIII.L, reprinted in the back of this volume.

M. Repeal Technical Terminations of Partnerships

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 190-193. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVIII.M, reprinted in the back of this volume.

N. Repeal Anti-Churning Rules of Section 197

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 194-196. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVIII.N, reprinted in the back of this volume.

O. Repeal Special Estimated Tax Payment Provision for Certain Insurance Companies

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 610-615. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVIII.O, reprinted in the back of this volume.

P. Repeal the Telephone Excise Tax

Present Law

In general

A three-percent Federal excise tax is imposed on amounts paid for communications services.[694] Communications services are defined as local telephone service, toll telephone service, and teletypewriter exchange service. The person paying for the service (*i.e.*, the consumer) is liable for payment of the tax.

Local telephone service is defined as the provision of voice-quality telephone access to a local telephone system that provides access to substantially all persons having telephone stations constituting a part of the local system and any facility or service provided in connection with this service.

Toll telephone service is defined as voice quality communication for which (1) there is a toll charge that varies with the distance and elapsed transmission time of each individual call and payment for which occurs in the United States, or (2) a service which, for a periodic charge (determined as a flat amount or upon the basis of total elapsed transmission time), entitles the subscriber to an unlimited number of telephone calls to or from an area outside the subscriber's local system area.

Teletypewriter exchange service refers to a data system that provides access from a teletypewriter or other data station to a teletypewriter exchange system and the privilege of intercommunication by that station with substantially all persons having teletypewriter or other data stations in the same exchange system. While it is understood that the system to which the definition was initially intended to apply is no longer in use, the definition may fit other services provided now or that may be provided in the future.

In general, the amount of tax is based on the sum of charges for taxable services included in the bill. If the person who renders the bill groups individual items for purposes of rendering the bill and computing the tax, then the tax base with respect to each such group is the sum of all items within that group. The tax on any remaining items not included in any such group is based on the charge for each item separately.

Special rules apply to the sale of prepaid telephone cards. These cards are subject to tax when a telecommunications carrier sells them to a non-telecommunications carrier (rather than when communication services are provided to the consumer). The base to which the tax is applied is the face amount of the card.

Exemptions

Present law provides for the following exemptions:

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[694] Sec. 4251.

- Public coin-operated service from the tax on local telephone service, and to the extent that the charge is less than 25 cents, from the toll telephone service tax.
- Service for the collection of news by the public press, news ticker, or radio broadcasting services (providing a news service as part of or similar to that of the public press), from the toll telephone service tax. (Local telephone service provided to the press is subject to tax.)
- Private communication service for which a separate charge is made, from the local telephone service tax.[695]
- Service provided to international organizations and the American National Red Cross.
- Toll telephone service provided to members of the Armed Services who are stationed in combat zones.
- Certain toll telephone service to common carriers (*i.e.*, public transportation companies), telephone or telegraph companies, or radio broadcasting stations or networks in the conduct of these businesses.
- Installation charges (including wires, poles, switchboards, or other equipment).
- Telephone service provided to nonprofit hospitals.
- Telephone service provided to State and local governments.
- Telephone service provided to nonprofit educational organizations.
- Telephone service provided to the government of the United States.
- Telephone service provided to qualified blood collector organizations.

Description of Proposal

The proposal repeals all taxes on communications services, including the tax on local telephone services.[696]

Effective date.−The proposal is effective for amounts paid pursuant to bills first rendered more than 90 days after the date of enactment.

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[695] Private communication service is defined as: (1) service that entitles the customer to exclusive or priority use of a communication channel or group of channels, or an intercommunication system for the customer's stations; (2) switching capacity, extension lines and stations, or other associated services provided in connection with services described in (1); and (3) channel mileage connecting a telephone outside a local service area with a central office in the local area.

Unlike the other exemptions, the special treatment for private communication service is accomplished by means of an exclusion from the definition of local telephone service rather than as a stated exemption.

[696] The estimated budgetary effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVIII.P, reprinted in the back of this volume.

Analysis

The present communications excise tax provisions were enacted before the development of most modern technology − the growth of computers and new electronic means of communication. The proliferation of wireless communications technology and the Internet, and in particular broadband access, has blurred the lines between "data" and "voice" quality service and between the functions of transmission and application.

The tax base for toll telephone service (long distance) is based on a charge which varies with the distance and elapsed transmission time of each individual call. This base has not kept up with the many ways that long distance services are charged. For example, long distance calling plans may be purchased by paying a fixed monthly fee for a limited (or even an unlimited) number of minutes usable nationwide. In addition, both local and long distance telephone services may be bundled together or with nontaxable services, including data (*e.g.*, text messaging, or wireless internet). Taxpayers challenged the IRS on the collection of taxes imposed on these bundled or unlimited calling plans arguing that the statute only imposes taxes on services based on distance and time. The IRS announced in 2006 that it would no longer collect taxes on "time-only" toll telephone services.[697] Taxpayers were allowed a refund of taxes paid for services billed after February 28, 2003 and before August 1, 2006. Consequently, the tax generally applies only to local telephone calling services.

The Administration argues that purely local telephone service will continue to be replaced over time by nontaxable services. They argue that the excise tax will increasingly be inequitable as those who continue to purchase purely local services subject to the telephone excise tax will increasingly be poor and elderly. Others add that these taxes are likely regressive, as they take up a larger share of earnings for low-income taxpayers compared with higher-income taxpayers.[698]

Some argue that there is no compelling policy argument for imposing taxes on communications services. Any excise tax distorts consumer decisions, and taxing new services and new technologies makes them more expensive, and, therefore, may slow their development.[699] They argue that affordable communications services are a necessity, a vital infrastructure for technological advancements. Taxing communications services use discourages not only the expansion of the communications infrastructure, but also the technologies that build

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[697] Notice 2006-50, 2006-25 I.R.B. 1141, May 25, 2006, amplified, clarified, and modified by Notice 2007-11, 2007-5 I.R.B 405, January 29, 2007.

[698] See, *e.g.*, Option 54, "Eliminate the Federal Communications Excise Tax and Universal Service Fund Fees," Congressional Budget Office, *Budget Options Volume 2*, August 2009, pp. 250-251.

[699] Indeed, some have argued that the costs imposed on society by taxing telecommunications are quite large in terms of the distortion of choice. See, *e.g.*, Jerry Hausman, "Taxation by Telecommunications Regulation," in James Poterba, ed., *Tax Policy and the Economy, Vol. 12*, Cambridge, MA: MIT Press, 1998, pp. 29-48. The estimated efficiency costs from taxation of wireless communication services are also large. See, *e.g.*, Jerry Hausman, "Efficiency Effects on the U.S. Economy from Wireless Taxation," *National Tax Journal*, vol. 53, no. 3, part 2, September 2000, pp. 733-742.

upon the infrastructure. On the other hand, the excise tax on communications services raises a significant amount of revenue.

The 2006 IRS decision eliminating the tax on unlimited or bundled long-distance services as well as innovations in communications technology result in a wide range of untaxed communications services. One alternative is to extend the tax to cover all forms of communications; however, extending the tax to all communications would require taxing internet access, bandwidth capacity, and the transmission of cable and satellite television, as these are close substitute means for delivery of information and other content. Some argue that taxing such communications would not only discourage their use, but also restrict investment and threaten economic growth, productivity, and jobs. These costs must be weighed against any benefits from the programs financed by the associated tax revenue.

Q. Increase Standard Mileage Rate for Automobile Use by Volunteers

Present Law

In general

In general, an itemized deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. Unreimbursed out-of-pocket expenditures made incident to providing donated services to a qualified charitable organization − such as out-of-pocket transportation expenses necessarily incurred in performing donated services − may qualify as a charitable contribution.[700] No charitable contribution deduction is allowed for traveling expenses (including expenses for meals and lodging) while away from home, whether paid directly or by reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation in such travel.[701]

In determining the amount treated as a charitable contribution where a taxpayer operates a vehicle in providing donated services to a charity, the taxpayer either may track and deduct actual out-of-pocket expenditures or, in the case of a passenger automobile, may use the charitable standard mileage rate. The charitable standard mileage rate is set by statute at 14 cents per mile.[702] The taxpayer may also deduct (under either computation method), any parking fees and tolls incurred in rendering the services, but may not deduct any amount (regardless of the computation method used) for general repair or maintenance expenses, depreciation, insurance, registration fees, etc. Regardless of the computation method used, the taxpayer must keep reliable written records of expenses incurred. For example, where a taxpayer uses the charitable standard mileage rate to determine a deduction, the IRS has stated that the taxpayer generally must maintain records of miles driven, time, place (or use), and purpose of the mileage. If the

[700] Treas. Reg. sec. 1.170A-1(g).

[701] Sec. 170(j).

[702] Sec. 170(i).

charitable standard mileage rate is not used to determine the deduction, the taxpayer generally must maintain reliable written records of actual expenses incurred.

In lieu of actual operating expenses, an optional standard mileage rate may be used in computing the deductible costs of business use of an automobile. The business standard mileage rate is determined by the IRS and updated periodically. For expenses paid or incurred on or after January 1, 2014, the business standard mileage rate specified by the IRS is 56 cents per mile.[703] Also, in lieu of actual operating expenses, an optional standard mileage rate may be used in computing deductible transportation expenses for medical purposes (section 213) or for work-related moving (section 217). The medical and moving standard mileage rates are determined by the IRS and updated periodically. For expenses paid or incurred on or after January 1, 2014, the rate for both such purposes is 23.5 cents per mile.[704]

The standard mileage rates for charitable, medical, and moving purposes are lower than the standard business rate because the charitable, medical, and moving rates generally cover only out-of-pocket operating expenses (including gasoline and oil) directly related to the use of the automobile in performing the donated services that a taxpayer may deduct as a charitable contribution or in traveling for medical or moving purposes. Such rates do not include costs that are not deductible for charitable, medical, or moving purposes, such as general maintenance expenses, depreciation, insurance, and registration fees. Such costs are, however, included in computing the business standard mileage rate.

Special, temporary rules for Hurricane Katrina and the Midwestern disaster area

Section 303 of the Katrina Emergency Tax Relief Act of 2005 allowed a taxpayer who used a vehicle in providing donated services to charity solely for the provision of relief related to Hurricane Katrina to compute the taxpayer's charitable mileage deduction using a rate (rounded to the next highest cent) equal to 70 percent of the business mileage rate in effect on the date of the contribution, rather than the charitable standard mileage rate generally in effect under section 170(i) (14 cents per mile). For purposes of this provision, the term vehicle includes any vehicle described in section 170(f)(12)(E)(i) (*i.e.*, a motor vehicle manufactured primarily for use on the public streets, roads, and highways). As an alternative to determining the amount of the deduction using the mileage rate described in the provision, a taxpayer may determine the amount of the deduction using actual out-of-pocket expenditures. The special rule applied for purposes of contributions made during the period beginning on August 25, 2005, and ending on December 31, 2006.

Section 702 of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 provides relief relating to a Midwestern disaster area during the period beginning on the applicable disaster date as defined in the Act and ending on December 31, 2008, generally identical to the relief provided for Hurricane Katrina (except that this relief relates to the Midwestern disaster rather than Hurricane Katrina). In addition to the present-law substantiation

[703] IRS Notice 2013-80.

[704] IRS Notice 2013-80.

requirements for use of the statutory mileage rate, it was intended that a taxpayer must substantiate that expenses were incurred in providing relief related to a Midwestern disaster area. The statutory rate applies if a taxpayer fails to substantiate that the expenses were incurred for the provision of such relief, assuming all other present-law requirements were met.

Description of Proposal

The proposal sets the standard mileage rate used for determining the charitable contribution deduction at the rate set by the IRS for purposes of the medical and moving expense deductions, as adjusted annually to reflect the estimated variable costs of operating a vehicle.[705]

Effective date.−The proposal is effective for taxable years beginning after December 31, 2014.

Analysis

Standard mileage rates generally improve compliance with and administration of the tax laws by reducing taxpayers' recordkeeping burdens and simplifying the determination of the deductible amount. Although taxpayers generally may track and deduct actual costs incurred, many taxpayers find it simpler to track only the number, date, and location of miles driven and to use a standard rate per mile to determine the amount of his or her deduction. This is particularly true in the case of miles driven for business purposes, where taxpayers are permitted to deduct not only the direct variable costs of operating the vehicle (such as fuel), but also a portion of general maintenance costs, such as insurance, depreciation, and registration fees. Maintaining records of actual operating costs while also allocating a portion of maintenance costs can be burdensome and can lead to uncertainty about the permissible deductible amount.

The burden of tracking deductible costs is somewhat less for taxpayers claiming a charitable, medical, or moving expense deduction, because vehicle maintenance costs are not deductible for such purposes. When not using a standard mileage rate, such taxpayers need only track and maintain records of the actual, variable operating costs incurred, such as fuel. Nevertheless, using a standard mileage rate can reduce such taxpayers' paperwork burdens and increase certainty regarding the deductible amount, which also simplifies the IRS's administration of the tax laws. Encouraging appropriate use of standard mileage rates thus may be in the interest of both taxpayers and the government.

The charitable standard mileage rate was increased in 1997 from 12 cents per mile to 14 cents per mile. The rate has not been adjusted since that time, and the IRS lacks the statutory authority to make periodic adjustments. The actual costs of operating an automobile, however, have increased substantially since 1997. The current standard mileage rate for medical and moving purposes, for example, is 23.5 cents per mile − 9.5 cents higher than the statutory charitable mileage rate.

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[705] The estimated budgetary effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XVIII.Q, reprinted in the back of this volume.

As the gap between actual operating costs and the charitable standard mileage rate widens, taxpayers' incentive to use the standard rate for miles driven in providing volunteer services arguably is diminished. Some taxpayers may, as a result, be more inclined to track and use actual operating costs in determining their charitable deductions, which increases taxpayers' recordkeeping and other compliance burdens and complicates IRS enforcement of the tax laws. Other taxpayers may view the compliance burdens of tracking actual expenses as too great and the standard mileage rate as inadequate. Such taxpayers may respond by limiting their volunteer activities, which could have a detrimental effect on charities that rely heavily on volunteer labor.

Finally, as indicated above, Congress has on two recent occasions temporarily increased the charitable mileage rate only for miles driven in providing volunteer relief services in connection with specifically described natural disasters. Allowing the charitable standard mileage rate to be periodically adjusted to reflect actual costs of operating an automobile would obviate the need for such a piecemeal approach.

PART XIX – USER FEE

A. Reform Inland Waterways Funding

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 717-718. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XIX.A, reprinted in the back of this volume.

PART XX – OTHER INITIATIVES

A. Allow Offset of Federal Income Tax Refunds to Collect Delinquent State Income Taxes for Out-of-State Residents

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 719-720. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XXI.A, reprinted in the back of this volume.

B. Authorize the Limited Sharing of Business Tax Return Information to Improve the Accuracy of Important Measures of the Economy

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 721-726. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XXI.B, reprinted in the back of this volume.

C. Eliminate Certain Reviews Conducted by the U.S. Treasury Inspector General for Tax Administration

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 727-729. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XXI.C, reprinted in the back of this volume.

D. Modify Indexing to Prevent Deflationary Adjustments

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 730-31. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCX-36-14), April 15, 2014, Item XXI.D, reprinted in the back of this volume.

ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2015 BUDGET PROPOSAL

JOINT COMMITTEE ON TAXATION
April 15, 2014
JCX-36-14

ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2015 BUDGET PROPOSAL [1]

Fiscal Years 2014 - 2024

[Millions of Dollars]

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2014-19	2014-24
I. Make Permanent Certain Tax Cuts Enacted in 2009														
1. Reduce the earnings threshold for the refundable portion of the child tax credit to $3,000 [2]	tyba 12/31/17	---	---	---	---	---	-11,703	-11,847	-11,928	-12,050	-12,086	-12,081	-11,703	-71,696
2. Earned income tax credit ("EITC") modification and simplification - increase in joint returns beginning and ending income level for phaseout by $5,000 indexed after 2008 [2]	tyba 12/31/17	---	---	---	---	-16	-1,615	-1,661	-1,692	-1,708	-1,754	-1,789	-1,631	-10,237
3. Extend the EITC for larger families [2]	tyba 12/31/17	---	---	---	---	-23	-2,296	-2,364	-2,438	-2,506	-2,583	-2,656	-2,319	-14,864
4. Extension of American opportunity tax credit [2]	tyba 12/31/17	---	---	---	---	-2,716	-13,491	-13,082	-12,840	-12,523	-12,040	-11,692	-16,208	-78,385
Total of Make Permanent Certain Tax Cuts Enacted in 2009		**---**	**---**	**---**	**---**	**-2,755**	**-29,105**	**-28,954**	**-28,898**	**-28,787**	**-28,463**	**-28,218**	**-31,861**	**-175,182**
II. Incentives for Manufacturing, Research, Clean Energy, and Insourcing and Creating Jobs														
A. Provide Tax Incentives for Locating Jobs and Business Activity in the United States and Remove Tax Deductions for Shipping Jobs Overseas	epoia DOE	-1	-10	-18	-20	-21	-22	-23	-24	-25	-26	-27	-92	-217
B. Enhance and Make Permanent the R&E Tax Credit	Epoia 12/31/13 & Epoia 12/31/14	-3,045	-5,843	-7,188	-8,264	-9,285	-10,265	-11,223	-12,183	-13,166	-14,176	-15,426	-43,892	-110,065
C. Extend Certain Employment Tax Credits Including Incentives for Hiring Veterans														
1. Permanently extend the work opportunity tax credit ("WOTC")	wptqiwbwftea 12/31/13 & 12/31/14	-399	-1,014	-1,301	-1,473	-1,610	-1,731	-1,838	-1,947	-2,062	-2,184	-2,313	-7,529	-17,872
2. Permanently extend and modify the Indian employment credit	wptqei tyba 12/31/13 & tyba 12/31/14	-21	-31	-15	-6	-2	-2	-2	-2	-2	-2	-2	-77	-87
D. Modify and Permanently Extend Renewable Electricity Production Tax Credit [2]	powcba 12/31/13	---	373	350	-391	-1,106	-1,780	-2,542	-3,200	-3,835	-4,443	-5,127	-2,554	-21,701
E. Modify and Permanently Extend the Deduction for Energy-Efficient Commercial Building Property	ppisa 12/31/14	-138	-240	-358	-522	-687	-703	-721	-715	-692	-695	-685	-2,649	-6,158
Total of Incentives for Manufacturing, Research, Clean Energy, and Insourcing and Creating Jobs		**-3,604**	**-6,765**	**-8,530**	**-10,676**	**-12,711**	**-14,503**	**-16,349**	**-18,071**	**-19,782**	**-21,526**	**-23,580**	**-56,793**	**-156,100**

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2014-19	2014-24
III. Tax Relief for Small Business														
A. Extend Increased Expensing for Small Business	qppisi tyba 12/31/13	-7,085	-12,440	-9,777	-8,199	-6,758	-5,354	-4,444	-3,954	-3,383	-3,609	-4,285	-49,614	-69,288
B. Eliminate Capital Gains Taxation on Investments in Small Business Stock	qsbsaa 12/31/13	2	15	22	29	-102	-943	-1,303	-1,566	-1,691	-1,778	-1,870	-977	-9,185
C. Increase the Limitations for Deductible New Business Expenditures and Consolidate Provisions for Start-Up and Organizational Expenditures	tyeo/a DOE	-36	-90	-127	-165	-206	-248	-292	-338	-385	-435	-486	-872	-2,807
D. Expand and Simplify the Tax Credit Provided to Qualified Small Employers for Non-Elective Contributions to Employee Health Insurance [2]	tyba 12/31/13	-80	-396	-365	-285	-330	-365	-394	-413	-429	-457	-480	-1,822	-3,995
Total of Tax Relief for Small Business		**-7,199**	**-12,911**	**-10,247**	**-8,621**	**-7,397**	**-6,910**	**-6,433**	**-6,270**	**-5,888**	**-6,279**	**-7,121**	**-53,284**	**-85,275**
IV. Incentives To Promote Regional Growth														
A. Extend and Modify the New Markets Tax Credit	DOE	-3	-20	-78	-194	-361	-549	-759	-983	-1,202	-1,382	-1,536	-1,205	-7,065
B. Restructure Assistance to New York City, Provide Tax Incentives for Transportation Infrastructure [2]	tyba 12/31/14	---	-200	-200	-200	-200	-200	-200	-200	-200	-200	-200	-1,000	-2,000
C. Reform and Expand the Low-Income Housing Tax Credit ("LIHTC")														
1. Allow states to convert private activity bond ("PAB") volume cap into LIHTCs that the State can allocate; and alternative qualification by building owners for PAB-related LIHTCs	[3]	---	-1	-11	-44	-94	-138	-176	-212	-249	-290	-335	-288	-1,550
2. Encourage mixed income occupancy by allowing LIHTC-supported projects to elect a criterion employing a restriction on average income	[4]	---	[5]	-2	-5	-8	-11	-14	-17	-20	-23	-26	-25	-125
3. Change formulas for 70 percent PV and 30 percent PV LIHTCs	amo/a DOE	---	-1	-1	-2	-4	-5	-5	-5	-6	-6	-6	-13	-41
4. Add preservation of Federally assisted affordable housing to allocation criteria	ami cyba DOE	*Negligible Revenue Effect*												
5. Make the LIHTC beneficial to Real Estate Investment Trusts ("REITs")	[6]	---	-1	-4	-11	-18	-25	-32	-39	-46	-53	-60	-59	-289
6. Implement Requirement that LIHTC-Supported Housing Protect Victims of Domestic Abuse	[7]	*Negligible Revenue Effect*												
Total of Incentives To Promote Regional Growth		**-3**	**-223**	**-296**	**-456**	**-685**	**-928**	**-1,186**	**-1,456**	**-1,723**	**-1,954**	**-2,163**	**-2,590**	**-11,070**
V. Reform U.S. International Tax System														
A. Defer Deduction of Interest Expense Related to Deferred Income of Foreign Subsidiaries	tyba 12/31/14	---	4,866	8,778	7,273	6,216	5,391	4,884	4,302	3,828	3,292	2,578	32,525	51,408
B. Determine the Foreign Tax Credit on a Pooling Basis	tyba 12/31/14	---	3,549	7,970	7,562	5,861	5,584	5,889	5,834	5,480	5,235	5,666	30,526	58,630
C. Tax Currently Excess Returns Associated with Transfers of Intangibles Offshore	ti tyba 12/31/14	---	962	2,180	2,291	2,353	2,213	2,100	2,204	2,278	2,322	2,388	9,998	21,290

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2014-19	2014-24
D. Limit Shifting of Income through Intangible Property Transfers	tyba 12/31/14	---	63	133	148	164	182	201	221	243	267	292	689	1,912
E. Disallow the Deduction for Non-Taxed Reinsurance Premiums Paid to Foreign Affiliates	pii tyba 12/31/14	---	293	710	765	823	884	949	1,018	1,092	1,171	1,256	3,474	8,959
F. Restrict Deductions for Excessive Interest of Members of Financial Reporting Groups	tyba 12/31/14	---	1,631	3,517	3,910	4,047	4,052	4,132	4,348	4,816	5,088	5,367	17,156	40,907
G. Modify Tax Rules for Dual Capacity Taxpayers	generally tyba 12/31/14	---	759	1,177	831	842	907	1,042	1,252	1,500	1,792	2,137	4,516	12,238
H. Tax Gain from the Sale of a Partnership Interest on Look-Through Basis	soea 12/31/14	---	153	227	238	249	260	271	283	295	307	319	1,128	2,603
I. Prevent Use of Leveraged Distributions from Related Foreign Corporations to Avoid Dividend Treatment	dma 12/31/14	---	137	211	235	261	289	319	351	386	423	463	1,134	3,077
J. Extend Section 338(h)(16) to Certain Asset Acquisitions	caaoa 12/31/14	---	60	100	100	100	100	100	100	100	100	100	460	960
K. Remove Foreign Taxes from a Section 902 Corporation's Foreign Tax Pool When Earnings are Eliminated	toa 12/31/14	---	13	27	30	33	36	40	44	49	53	58	139	382
L. Create a New Category of Subpart F Income for Transactions Involving Digital Goods or Services	tyba 12/31/14	---	842	1,883	1,927	2,017	2,097	2,121	2,141	2,219	2,315	2,350	8,765	19,911
M. Prevent Avoidance of Foreign Base Company Sales Income through Manufacturing Services Arrangements	tyba 12/31/14	---	715	1,431	1,459	1,451	1,449	1,469	1,439	1,501	1,586	1,628	6,506	14,130
N. Restrict the Use of Hybrid Arrangements that Create Stateless Income	tyba 12/31/14	---	30	61	70	73	75	76	76	77	77	78	309	694
O. Limit the Application of Exceptions Under Subpart F for Certain Transactions that Use Reverse Hybrids to Create Stateless Income	tyba 12/31/14	---	33	56	61	67	72	77	85	95	104	114	287	763
P. Limit the Ability of Domestic Entities to Expatriate	Tca 12/31/14	---	78	351	637	962	1,351	1,758	2,215	2,740	3,291	3,867	3,380	17,251
Total of Reform U.S. International Tax System		---	**14,184**	**28,812**	**27,537**	**25,519**	**24,942**	**25,428**	**25,913**	**26,699**	**27,423**	**28,661**	**120,992**	**255,115**
VI. Reform Treatment of Financial and Insurance Industry Institutions and Products														
A. Require that Derivative Contracts be Marked to Market with Resulting Gain or Loss Treated as Ordinary	dceia 12/31/14	---	493	3,141	2,247	1,842	1,586	1,227	1,068	948	840	875	9,309	14,267
B. Modify Rules that Apply to Sales of Life Insurance Contracts	[8]	---	20	40	52	64	76	90	107	124	141	162	252	876
C. Modify Proration Rules for Life Insurance Company General and Separate Accounts	tyba 12/31/14	---	180	492	536	588	647	660	673	687	701	715	2,443	5,879
D. Extend Pro Rata Interest Expense Disallowance for Corporate-Owned Life Insurance	[9]	---	42	188	382	478	626	762	950	1,162	1,344	1,439	1,716	7,373
Total of Reform Treatment of Financial and Insurance Industry Institutions and Products		---	**735**	**3,861**	**3,217**	**2,972**	**2,935**	**2,739**	**2,798**	**2,921**	**3,026**	**3,191**	**13,720**	**28,395**

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2014-19	2014-24
VII. Eliminate Fossil Fuel Preferences														
A. Eliminate Oil And Gas Preferences														
1. Repeal enhanced oil recovery ("EOR") credit	tyba 12/31/14	*No Revenue Effect*												
2. Repeal credit for oil and gas produced from marginal wells	tyba 12/31/14	*No Revenue Effect*												
3. Repeal expensing of intangible drilling costs	cpoia 12/31/14	---	1,667	2,391	2,142	1,936	1,750	1,392	771	298	188	71	9,887	12,606
4. Repeal deduction for tertiary injectants	apoia 12/31/14	---	4	7	8	8	7	5	5	5	4	4	34	57
5. Repeal exception to passive loss limitations for working interests in oil and natural gas properties	tyba 12/31/14	---	11	22	22	22	23	24	24	25	25	26	100	224
6. Repeal percentage depletion for oil and natural gas wells	tyba 12/31/14	---	1,025	1,606	1,616	1,650	1,714	1,775	1,820	1,852	1,877	1,900	7,611	16,835
7. Repeal domestic manufacturing deduction for oil and natural gas production	tyba 12/31/14	---	656	1,669	1,756	1,829	1,839	1,850	1,883	1,921	1,963	2,010	7,748	17,374
8. Increase geological and geophysical amortization period for independent producers to seven years	apoia 12/31/14	---	184	311	296	248	201	154	96	48	33	32	1,241	1,604
B. Eliminate Coal Preferences														
1. Repeal expensing of exploration and development costs	cpoia 12/31/14	---	54	81	79	77	76	77	83	91	94	95	367	806
2. Repeal percentage depletion for hard mineral fossil fuels	tyba 12/31/14	---	38	59	60	62	64	65	68	71	74	77	283	638
3. Repeal capital gains treatment for royalties	ari tyba 12/31/14	4	26	31	54	56	58	60	62	65	67	172	230	656
4. Repeal domestic manufacturing deduction for the production of coal and other hard mineral fossil fuels	tyba 12/31/14	---	26	67	70	70	70	72	73	75	77	79	303	678
Total of Eliminate Fossil Fuel Preferences		**4**	**3,691**	**6,244**	**6,103**	**5,958**	**5,802**	**5,474**	**4,885**	**4,451**	**4,402**	**4,466**	**27,804**	**51,478**
VIII. Other Revenue Changes and Loophole Closers														
A. Repeal the Excise Tax Credit for Distilled Spirits with Flavor and Wine Additives	aspioiiUSa 12/31/14	---	85	114	114	114	115	115	116	116	117	117	542	1,124
B. Repeal Last-In, First-Out ("LIFO") Method of Accounting for Inventories	ftyba 12/31/14	---	5,498	11,014	11,051	11,089	11,127	11,166	11,206	11,247	11,289	11,332	49,778	106,019
C. Repeal Lower-Of- Cost-or-Market ("LCM") Inventory Accounting Method	tyba 12/31/14	---	562	1124	1126	1128	609	91	93	95	97	98	4,550	5,023
D. Modify Depreciation Rules for Purchases of General Aviation Passenger Aircraft	ppisa 12/31/14	---	82	285	460	532	611	648	504	305	206	169	1,970	3,803
E. Repeal Gain Limitation for Dividends Received in Reorganization Exchanges	tyba 12/31/14	---	20	65	65	65	65	70	70	73	73	75	280	641
F. Expand the Definition of Built-In Loss for Purposes of Partnership Loss Transfers	soea DOE	6	36	47	51	53	56	58	62	64	67	70	249	570
G. Extend Partnership Basis Limitation Rules to Nondeductible Expenditures	ptybo/a DOE	12	82	108	114	121	128	134	141	147	153	160	565	1,300
H. Limit the Importation of Losses Under Related Party Loss Limitation Rules	tma DOE	22	74	93	98	104	109	115	120	126	131	137	500	1,129

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2014-19	2014-24
I. Deny Deduction for Punitive Damages	dpoia 12/31/15	---	---	27	37	38	39	40	42	43	44	45	141	355
J. Modify Like-Kind Exchange Rules for Real Property	lkeca 12/31/14	[10]	46	100	169	283	467	725	1,096	1,649	2,485	3,769	1,065	10,789
K. Conform Corporate Ownership Standards	toa 12/31/14	---	15	21	21	21	22	23	24	25	26	27	100	225
L. Prevent Elimination of Earnings and Profits Through Distributions of Certain Stock	DOE	2	17	31	37	38	40	42	43	45	47	49	165	391
Total of Other Revenue Changes and Loophole Closers		**42**	**6,517**	**13,029**	**13,343**	**13,586**	**13,388**	**13,228**	**13,516**	**13,935**	**14,735**	**16,049**	**59,905**	**131,370**
IX. Incentives for Job Creation, Clean Energy, and Manufacturing														
A. Provide Additional Tax Credits for Investment in Qualified Property Used in a Qualified Advanced Energy Manufacturing Project	DOE	---	-605	-673	-355	-162	-104	-18	45	46	21	4	-1,898	-1,800
B. Designate Promise Zones														
1. Employment credit provided to businesses that employ zone residents	DOE	---	-53	-205	-361	-512	-606	-608	-609	-610	-612	-613	-1,738	-4,790
2. Allow qualified property placed in service within the zone to be eligible for additional first-year depreciation of 100% of the adjusted basis of the property	DOE	---	-165	-431	-326	-254	-192	-139	-105	-87	-81	-83	-1,368	-1,862
C. Provide New Manufacturing Communities Tax Credit	qiai 2015-2017	---	---	-9	-47	-165	-336	-504	-620	-694	-737	-721	-557	-3,833
D. Provide a Tax Credit for the Production of Advanced Technology Vehicles	vpisa 12/31/14 & before 1/1/22	---	-272	-394	-368	-415	-400	-342	-332	-189	-67	-31	-1,850	-2,811
E. Provide a Tax Credit for Medium- and Heavy-Duty Alternative-Fuel Commercial Vehicles	vpisa 12/31/14 & before 1/1/21	---	-66	-107	-126	-151	-178	-199	-110	-60	-53	-41	-629	-1,094
F. Modify Tax-Exempt Bonds for Indian Tribal Governments	DOE	---	-4	-7	-12	-17	-22	-28	-34	-40	-47	-54	-62	-266
G. Extend the Tax Credit for Cellulosic Biofuels (sunset 12/31/24)	fsoua 12/31/13	-15	-28	-33	-40	-47	-56	-67	-68	-61	-50	-33	-219	-499
H. Modify and Extend the Tax Credit for the Construction of Energy-Efficient New Homes	haa 12/31/14 & before 1/1/25	-96	-131	-144	-172	-197	-217	-232	-237	-238	-237	-233	-957	-2,134
I. Reduce Excise Taxes on Liquefied Natural Gas to Bring Into Parity with Diesel	fsoua 12/31/14	---	-2	-3	-3	-3	-3	-3	-3	-4	-4	-4	-15	-34
Total of Incentives for Job Creation, Clean Energy, and Manufacturing		**-111**	**-1,326**	**-2,006**	**-1,810**	**-1,923**	**-2,114**	**-2,140**	**-2,073**	**-1,937**	**-1,867**	**-1,809**	**-9,293**	**-19,123**
X. Incentives for Investment in Infrastructure														
A. Provide America Fast Forward Bonds and Expand Eligible Uses [2]	bio/a 1/1/5	---	-7	-58	-151	-253	-364	-477	-594	-714	-837	-964	-833	-4,418
B. Allow Current Refundings of State and Local Governmental Bonds	DOE	*Negligible Revenue Effect*												

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2014-19	2014-24
C. Repeal the $150 Million Nonhospital Bond Limitation on all Qualified 501(C)(3) Bonds	bia DOE	[5]	[5]	-2	-4	-6	-8	-11	-13	-16	-18	-21	-20	-98
D. Increase National Limitation Amount for Qualified Highway or Surface Freight Transfer Facility Bonds	DOE	[5]	[5]	[5]	-2	-10	-23	-35	-45	-49	-49	-49	-35	-262
E. Eliminate the Volume Cap for Private Activity Bonds for Water Infrastructure	bia DOE	[5]	[5]	-1	-3	-6	-11	-16	-23	-29	-35	-43	-20	-166
F. Increase the 25-Percent Limit on Land Acquisition Restriction on Private Activity Bonds	bia DOE	[5]	[5]	-3	-8	-14	-22	-30	-37	-45	-53	-62	-47	-274
G. Allow More Flexible Research Arrangements for Purposes of Private Business Use Limits	raeia DOE	[5]	[5]	-1	-3	-5	-8	-10	-13	-15	-17	-20	-17	-92
H. Repeal the Government Ownership Requirement for Certain Types of Exempt Facility Bonds	bia DOE	-2	-25	-99	-198	-274	-335	-397	-459	-523	-587	-653	-932	-3,551
I. Exempt Certain Foreign Pension Funds from the Application of the Foreign Investment in Real Property Tax Act ("FIRPTA")	doUSrpioa 12/31/14	---	-129	-191	-200	-209	-219	-228	-237	-247	-258	-268	-947	-2,186
Total of Incentives for Investment in Infrastructure		**-2**	**-161**	**-355**	**-569**	-777	**-990**	**-1,204**	**-1,421**	**-1,638**	**-1,854**	**-2,080**	**-2,851**	**-11,047**
XI. Tax Cuts for Families and Individuals														
A. Expand the EITC for Workers without Qualifying Children [2]	tyba 12/31/14	---	-65	-6,470	-6,475	-6,481	-6,537	-6,673	-6,826	-6,925	-7,041	-7,164	-26,028	-60,657
B. Provide for Automatic Enrollment in Individual Retirement Accounts ("IRAs") or Annuities, Including a Small Employer Tax Credit, and Double the Tax Credit for Small Employer Plan Start-Up Costs [2]	tyba 12/31/15	---	---	-284	-1,142	-1,189	-1,267	-1,354	-1,434	-1,508	-1,612	-1,701	-3,882	-11,491
C. Expand the Child and Dependent Care Tax Credit [2]	tyba 12/31/14	---	-12	-1,205	-1,206	-1,179	-1,148	-1,110	-1,072	-1,037	-1,006	-975	-4,749	-9,947
D. Extend Exclusion from Income for Cancellation of Certain Home Mortgage Debt (sunset 12/31/15)	doioa 12/31/14	-471	-3,012	-2,139	-1,187	---	---	---	---	---	---	---	-6,810	-6,810
E. Provide Exclusion from Income for Student Loan Forgiveness for Students in Certain Income-Based or Income-Contingent Repayment Programs Who Have Completed Payment Obligations	lfa 12/31/14	---	---	---	---	---	---	-1	-1	-1	-2	-3	---	-7
F. Provide Exclusion from Income for Student Loan Forgiveness and for Certain Scholarship Amounts for Participants in the Indian Health Service Health Professions Programs [11]	tyba 12/31/14	---	-3	-14	-14	-14	-15	-15	-15	-16	-16	-16	-60	-138
G. Make Pell Grants Excludable from Income and from Tax Credit Calculations [2]	tyba 12/31/14	---	-23	-263	-256	-241	-232	-221	-211	-202	-195	-187	-1,015	-2,031
Total of Tax Cuts for Families and Individuals		**-471**	**-3,115**	**-10,375**	**-10,280**	**-9,103**	**-9,199**	**-9,373**	**-9,559**	**-9,689**	**-9,872**	**-10,046**	**-42,544**	**-91,081**
XII. Upper-Income Tax Provisions														
A. Reduce the Value of Certain Tax Expenditures	tyba 12/31/14	-486	13,612	43,648	43,375	46,812	49,970	53,137	56,573	60,089	63,609	67,297	196,931	497,636

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2014-19	2014-24
B. Implement the Buffet Rule by Imposing a New "Fair Share Tax" [12]	tyba 12/31/14	2,703	14,178	-4,717	5,439	5,980	6,565	7,023	7,458	7,914	8,321	8,757	30,148	69,621
Total of Upper-Income Tax Provisions		**2,217**	**27,790**	**38,931**	**48,814**	**52,792**	**56,535**	**60,160**	**64,031**	**68,003**	**71,930**	**76,054**	**227,079**	**567,257**
XIII. Modify Estate and Gift Tax Provisions														
A. Restore the Estate, Gift and Generation-Skipping Transfer ("GST") Tax Parameters in Effect in 2009 with Portability of Exemption Amount Between Spouses	dda & tma 12/31/17	---	---	39	292	1,165	7,710	9,933	13,150	16,605	17,733	18,498	9,206	85,125
B. Require Consistency in Value for Transfer and Income Tax Purposes	ta tyoe	---	20	137	149	160	182	196	208	217	226	234	648	1,729
C. Require a Minimum Term for Grantor Retained Annuity Trusts ("GRATs")	tca DOE	---	---	10	48	105	200	317	448	598	771	905	363	3,402
D. Limit Duration of GST Tax Exemption	tca DOE	*Negligible Revenue Effect*												
E. Coordinate Certain Income and Transfer Tax Rules Applicable to Grantor Trusts	tco/a DOE	---	1	9	40	87	170	275	395	541	714	867	308	3,100
F. Extend the Lien on Estate Tax Deferrals where Estate Consists Largely of Interest in Closely Held Business	[13]	---	3	4	5	8	9	8	8	9	11	11	28	75
G. Clarify GST Tax Treatment of Health and Education Exclusion Trusts	[14]	---	-10	-18	-18	-16	-15	-14	-12	-10	-8	-7	-77	-129
H. Simplify Gift Tax Exclusion for Annual Gifts	gma tyoe	---	---	31	87	146	230	302	389	451	545	607	494	2,788
I. Expand Applicability of Definition of Executor	DOE	*Negligible Revenue Effect*												
Total of Modify Estate and Gift Tax Provisions		**---**	**14**	**212**	**603**	**1,655**	**8,487**	**11,017**	**14,586**	**18,410**	**19,992**	**21,116**	**10,970**	**96,090**
XIV. Reform Treatment of Financial and Insurance Industry Institutions and Products														
A. Impose a Financial Crisis Responsibility Fee	1/1/16	---	---	2,631	5,284	5,391	5,484	5,561	5,692	5,821	5,956	6,093	18,791	47,917
B. Require Current Inclusion in Income of Accrued Market Discount and Limit the Accrual Amount for Distressed Debt	dsaa 12/31/14	---	11	40	74	104	118	116	104	87	68	51	347	773
C. Require that the Cost Basis of Stock that is a Covered Security Must Be Determined Using an Average Cost Basis Method	psao/a 1/1/15	-2	-10	-6	24	85	128	160	209	265	312	360	219	1,525
Total of Reform Treatment of Financial and Insurance Industry Institutions and Products		**-2**	**1**	**2,664**	**5,382**	**5,580**	**5,729**	**5,837**	**6,005**	**6,173**	**6,335**	**6,504**	**19,357**	**50,214**
XV. Loophole Closers														
A. Tax Carried (Profits) Interests as Ordinary Income	tyea 12/31/14	346	779	1,644	2,263	2,225	1,976	1,868	1,702	1,579	1,452	1,341	9,233	17,175
B. Require Non-Spouse Beneficiaries of IRA or Annuity Owners and Retirement Plan Participants to Take Inherited Distributions Over No More Than Five Years	[15]	---	[5]	37	141	260	434	828	879	839	796	751	872	4,965

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2014-19	2014-24
C. Limit the Total Accrual of Tax-Favored Retirement Benefits [16]	caaf tyba 12/31/14	---	293	398	407	418	429	440	452	466	479	493	1,945	4,275
D. Conform Self-Employment Contributions Act ("SECA") Taxes For Professional Service Businesses [17]	tyba 12/31/14	---	999	1,913	2,178	2,437	2,609	2,712	2,830	2,965	3,095	3,225	10,137	24,964
Total of Loophole Closers		**346**	**2,071**	**3,992**	**4,989**	**5,340**	**5,448**	**5,848**	**5,863**	**5,849**	**5,822**	**5,810**	**22,187**	**51,379**
XVI. Other Revenue Raisers														
A. Levy a Fee on the Production of Hardrock Minerals to Restore Abandoned Mines [18]	rma 12/31/15	---	---	112	149	148	148	148	148	148	148	148	557	1,297
B. Return Fees on the Production of Coal to Pre-2006 Levels to Restore Abandoned Mines (sunset 9/30/21) [18]	Cma 9/30/14	---	39	36	37	38	39	40	40	---	---	---	189	269
C. Increase Oil Spill Liability Trust Fund Financing Rate by One Cent and Update the Law to Include Other Sources of Crudes [19]	[20]	---	65	104	113	119	123	127	132	137	142	147	524	1,209
D. Reinstate Superfund Taxes														
1. Reinstate and Extend Superfund Excise Taxes	pa 12/31/14 & before 1/1/25	---	434	593	601	606	610	613	615	620	626	631	2,845	5,949
2. Reinstate Superfund Environmental Income Tax	tyba 12/31/14 & before 1/1/25	---	940	1,509	1,591	1,625	1,637	1,661	1,699	1,743	1,789	1,805	7,301	15,997
E. Increase Tobacco Taxes and Index for Inflation [2] [21]	ara 12/31/14	---	6,136	7,551	7,459	7,672	7,922	8,161	8,398	8,691	8,788	8,924	36,740	79,703
F. Make the 0.2 Percent Unemployment Insurance Surtax Permanent [18]	wpo/a 1/1/15	---	1,050	1,417	1,439	1,458	1,473	1,486	1,498	1,510	1,523	1,536	6,837	14,390
G. Provide Short-Term Tax Relief to Employers and Expand Federal Unemployment Tax Act ("FUTA") Base [2] [18]	DOE	-471	-4,825	-4,338	5,082	8,258	1,291	-1,072	1,661	3,362	5,648	6,149	4,997	20,745
H. Enhance and Modify the Conservation Easement Deduction														
1. Enhance and make permanent incentives for the donation of conservation easements	cmoaa 1/1/14	-23	-64	-77	-81	-84	-94	-111	-127	-142	-156	-169	-422	-1,128
2. Eliminate the deduction for contributions of conservation easements on golf courses	cma DOE	5	17	24	24	25	25	26	26	27	28	28	120	255
3. Restrict deductions and harmonize the rules for contributions of conservation easements for historic preservation	cma DOE	3	16	27	28	29	29	30	31	32	33	34	131	292
I. Eliminate Deduction for Dividends on Stock of Publicly-Traded Corporations Held in Employee Stock Ownership Plans	dadpa DOE	87	356	549	568	588	609	630	652	675	698	723	2,757	6,135
Total of Other Revenue Raisers		**-399**	**4,164**	**7,507**	**17,009**	**20,482**	**13,812**	**11,739**	**14,773**	**16,803**	**19,267**	**19,956**	**62,576**	**145,113**

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2014-19	2014-24
XVII. Reduce the Tax Gap and Make Reforms														
A. Expand Information Reporting														
1. Require information reporting for private separate accounts of life insurance companies	tyba 12/31/14	*Negligible Revenue Effect*												
2. Require a certified taxpayer identification number ("TIN") from contractors and allow certain withholding	pmtca 12/31/14	---	6	51	35	37	39	41	43	46	48	51	169	398
3. Modify reporting of tuition expenses and scholarships on Form 1098-T [2]	tyba 12/31/14	---	4	43	45	48	51	54	57	60	64	74	191	500
4. Provide for reciprocal reporting of information in connection with the implementation of the Foreign Account Tax Compliance Act ("FATCA")	rrtbfa 12/31/15	---	---	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	1
5. Provide authority to readily share beneficial ownership of U.S. companies with law enforcement	DOE	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	1
B. Improve Compliance By Businesses														
1. Require greater electronic filing of returns	tyea 12/31/14	*No Revenue Effect*												
2. Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes	[22]	*Negligible Revenue Effect*												
3. Increase certainty with respect to worker classification [2] [23]	generally DOE	---	145	493	878	1,038	1,096	1,101	1,089	1,089	1,105	1,127	3,650	9,161
4. Increase Information Sharing to Administer Excise Taxes	DOE	---	3	5	7	10	12	15	18	20	22	23	37	135
C. Strengthen Tax Administration														
1. Impose liability on shareholders to collect unpaid income taxes of applicable corporations	[24]	28	167	168	135	141	147	153	160	166	173	180	785	1,617
2. Increase levy authority for payments to Medicare providers with delinquent tax debt	pma DOE	[10]	57	78	80	81	83	84	86	88	90	91	379	818
3. Implement a program integrity statutory cap adjustment for tax administration [18] [25]	DOE	---	369	1,248	2,539	3,800	4,972	5,840	6,304	6,389	6,344	6,224	12,928	44,029
4. Enhance unemployment insurance program integrity [2] [18] [25]	10/1/14	---	25	54	57	54	52	50	49	50	51	54	242	496
5. Streamline audit and adjustment procedures for large partnerships	[26]	---	40	159	193	191	189	184	186	191	195	200	772	1,728
6. Revise offer-in-compromise application rules	oicsa DOE	-5	-5	[27]	[27]	[27]	[27]	[27]	[27]	[27]	[27]	[27]	-10	-10
7. Expand Internal Revenue Service ("IRS") access to information in the National Directory of New Hires for tax administration purposes	DOE	*No Revenue Effect*												
8. Make repeated willful failure to file a tax return a felony	rrtbfa 12/31/14	*Negligible Revenue Effect*												
9. Facilitate tax compliance with local jurisdictions	Dma DOE	*Negligible Revenue Effect*												
10. Extend statute of limitations where State adjustment affects Federal tax liability	rrtbfa 12/31/14	---	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	1	2
11. Improve investigative disclosure statute	Dma DOE	*Negligible Revenue Effect*												

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2014-19	2014-24
12. Require taxpayers who prepare their returns electronically but file their returns on paper to print their returns with a scannable code	trfa 12/31/14	*No Revenue Effect*												
13. Allow the IRS to absorb credit and debit card processing fees for certain tax payments	pma DOE	*Negligible Revenue Effect*												
14. Provide the IRS with Greater Flexibility to Address Correctable Errors [2]	DOE	[10]	[10]	13	13	14	14	14	15	15	16	16	53	129
15. Make e-filing mandatory for exempt organizations	generally tyba DOE	*No Revenue Effect*												
16. Authorize the Department of the Treasury to require additional information to be included in electronically filed Form 5500 Annual Reports and electronic filing of certain other employee benefit plan reports	pyba 12/31/14	*Negligible Revenue Effect*												
17. Impose a penalty on failure to comply with electronic filing requirements	rrtbfea 12/31/14	*Negligible Revenue Effect*												
18. Provide whistleblowers with protection from retaliation	DOE	*Negligible Revenue Effect*												
19. Provide stronger protection from improper disclosure of taxpayer information in whistleblower actions	DOE	*No Revenue Effect*												
20. Index all penalties to inflation	DOE	---	1	2	4	6	9	12	15	18	21	25	23	115
21. Extend paid preparer EITC due diligence requirements to the child tax credit ("CTC") [2]	tyba 12/31/14	---	[10]	5	5	5	5	5	5	5	5	5	19	43
22. Extend IRS authority to require truncated Social Security Numbers on Form W–2	DOE	*Negligible Revenue Effect*												
23. Add tax crimes to the Aggravated Identity Theft Statute	DOE	*Negligible Revenue Effect*												
24. Impose a civil penalty on tax identity theft crimes	DOE	*Negligible Revenue Effect*												
25. Allow States to send notices of intent to offset Federal tax refunds to collect State tax obligations by regular first-class mail instead of certified mail	DOE	*Negligible Revenue Effect*												
26. Explicitly provide that the Department of the Treasury and the IRS have authority to regulate all paid return preparers [2]	DOE	[10]	5	10	11	12	13	14	15	15	16	17	51	129
27. Rationalize tax return filing due dates so they are staggered [2]	rrtbfa 12/31/14	---	-1,774	-57	32	88	85	71	69	75	73	2,107	-1,626	769
28. Increase the penalty applicable to paid tax preparers who engage in willful or reckless conduct	rrtbfa 12/31/14	---	[10]	[10]	1	1	1	1	1	1	1	1	3	8
29. Enhance administrability of the appraiser penalty	rrtbfa 12/31/14	*Negligible Revenue Effect*												
Total of Reduce the Tax Gap and Make Reforms		**23**	**-957**	**2,272**	**4,034**	**5,526**	**6,768**	**7,640**	**8,111**	**8,229**	**8,224**	**10,196**	**17,667**	**60,069**
XVIII. Simplify the Tax System														
A. Simplify the Rules for Claiming the EITC for Workers Without Qualifying Children [2]	tyba 12/31/14	---	-1	-96	-98	-101	-104	-107	-110	-112	-114	-116	-399	-958

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2014-19	2014-24
B. Modify Adoption Credit to Allow Tribal Determination of Special Needs	tyba 12/31/14	---	[5]	-1	-1	-1	-1	-1	-1	-1	-1	-1	-3	-7
C. Simplify Minimum Required Distribution ("MRD") Rules	[28]	---	-7	-33	-43	-35	-12	14	49	94	147	211	-131	385
D. Allow All Inherited Plan and IRA Accounts to be Rolled Over Within 60 Days	dma 12/31/14	*Negligible Revenue Effect*												
E. Repeal Non-Qualified Preferred Stock ("NQPS") Designation	sia 12/31/14	---	5	11	12	12	13	13	14	14	15	15	53	124
F. Repeal Preferential Dividend Rule for Publicly Traded and Publicly Offered REITs	dmi tyba DOE	*Negligible Revenue Effect*												
G. Reform Excise Tax Based on Investment Income of Private Foundations	tyba DOE	---	-9	-12	-13	-13	-14	-14	-15	-16	-16	-17	-60	-138
H. Remove Bonding Requirements for Certain Taxpayers Subject to Federal Excise Taxes on Distilled Spirits, Wine, and Beer	90da DOE	[5]	[5]	[5]	[5]	[5]	[5]	[5]	[5]	[5]	[5]	[5]	[5]	[5]
I. Simplify Arbitrage Investment Restrictions	bia DOE	-7	-38	-55	-62	-68	-71	-72	-74	-77	-79	-82	-300	-685
J. Simplify Single-Family Housing Mortgage Bond Targeting Requirements	bia DOE	---	-7	-15	-29	-44	-61	-78	-95	-113	-131	-149	-156	-722
K. Streamline Private Business Limits on Governmental Bonds	bia DOE	---	-1	-3	-5	-6	-8	-11	-13	-15	-17	-19	-24	-98
L. Exclude Self-Constructed Assets of Small Taxpayers from the Uniform Capitalization ("UNICAP") Rules	cii tyba 12/31/14	---	-44	-89	-93	-96	-99	-103	-106	-109	-113	-116	-421	-967
M. Repeal Technical Terminations of Partnerships	to/a 12/31/14	---	10	15	17	18	19	19	20	21	22	19	79	180
N. Repeal Anti-Churning Rules of Code Section 197	aa 12/31/14	---	-27	-94	-201	-335	-469	-536	-536	-536	-536	-536	-1,125	-3,803
O. Repeal Special Estimated Tax Payment Provision for Certain Insurance Companies	tyba 12/31/14	*Negligible Revenue Effect*												
P. Repeal the Telephone Excise Tax	[29]	---	-592	-554	-518	-485	-454	-425	-398	-372	-348	-326	-2,603	-4,470
Q. Increase the Standard Mileage Rate for Automobile Use by Volunteers	tyba 12/31/4	---	-12	-47	-48	-50	-52	-53	-55	-57	-59	-61	-208	-493
Total of Simplify the Tax System		**-7**	**-723**	**-973**	**-1,081**	**-1,204**	**-1,312**	**-1,354**	**-1,320**	**-1,279**	**-1,231**	**-1,178**	**-5,298**	**-11,652**
XIX. User Fees														
A. Reform Inland Waterways Funding [18]	vuicwtba 9/30/14	---	61	84	84	84	84	84	84	84	84	84	397	817
B. Increase fees for Migratory Bird Hunting and Conservation Stamps [18]	10/1/14	---	13	13	13	13	13	13	13	14	14	14	65	132
C. Establish a Mandatory Surcharge for Air Traffic Services	fba 9/30/14	---	688	820	836	847	859	870	883	895	907	919	4,051	8,525
D. Reauthorize Special Assessment On Domestic Nuclear Utilities [18]	10/1/14	---	150	152	155	158	162	165	170	173	177	181	777	1,643
E. Permanently Extend and Reallocate the Travel Promotion Surcharge [18]	10/1/15	---	---	138	142	146	150	155	160	164	169	174	576	1,398
Total of User Fees		**---**	**911**	**1,206**	**1,230**	**1,248**	**1,268**	**1,287**	**1,310**	**1,330**	**1,351**	**1,372**	**5,865**	**12,515**

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2014-19	2014-24
XX. Trade Initiative - Extend the Generalized System of Preferences (sunset 12/31/15) [18]	**8/1/13**	**-271**	**-583**	**-109**	**---**	**---**	**---**	**---**	**---**	**---**	**---**	**---**	**-962**	**-962**
XXI. Other Initiatives														
A. Allow Offset of Federal Income Tax Refunds to Collect Delinquent State Income Taxes for Out-of-State Residents	DOE	*Negligible Revenue Effect*												
B. Authorize the Limited Sharing of Business Tax Return Information to Improve the Accuracy of Important Measures of the Economy	DOE	*No Revenue Effect*												
C. Eliminate Certain Reviews Conducted by the U.S. Treasury Inspector General for Tax Administration ("TIGTA")	tyba 12/31/14	*No Revenue Effect*												
D. Modify Indexing to Prevent Deflationary Adjustments	DOE	*No Revenue Effect*												
E. Transition to a Reformed Business Tax System [30]	DOE	*Proposal Requires Specification*												
F. Enact Comprehensive Immigration Reform [31]	DOE	*Proposal Requires Specification*												
Total of Other Initiatives		***Negligible Revenue Effect***												
NET TOTAL		**-9,436**	**33,315**	**75,841**	**98,770**	**104,103**	**80,054**	**83,403**	**92,724**	**102,081**	**109,461**	**117,179**	**382,645**	**887,502**

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding. The date of enactment is generally assumed to be July 1, 2014.

[Legend and Footnotes for JCX-36-14 appear on the following pages]

Legend for JCX-36-14:

Legend for "Effective" column:

aa = acquisitions after
amo/a = allocations made on or after
ami = allocations made in
apoia = amounts paid or incurred after
ara = articles removed after
ari = amounts realized in
aspioiiUSa = all spirits produced in or imported into the United States after
bio/a = bonds issued on or after
caaf = contributions and accruals for
caaoa = covered asset acquisitions occurring after
cii = costs incurred in
Cma = coal mined after
cma = contributions made after
cmoaa = contributions made on and after
cpoia = costs paid or incurred after
cyba = calendar years beginning after
dadpa = dividends and distributions paid after
dceia = derivative contracts entered into after
dda = decedents dying after
Dma = disclosures made after
dma = distributions made after
dmi = distributions made in
DOE = date of enactment
doioa = discharge of indebtedness occurring after
doUSrpioa = dispositions of U.S. real property interests occurring after
dpoia = damages paid or incurred after
dsaa = debt securities acquired after
epoia = expenses paid or incurred after
Epoia = expenditures paid or incurred after
fba = flights beginning after
fsoua = fuel sold or used after
ftyba = first taxable year beginning after
gma = gifts made after
lfa = loans forgiven after
lkeca = like-kind exchanges completed after
oicsa = offers-in-compromise submitted after
pa = periods after
pii = policies issued in
pma = payments made after
pmtca = payments made to contractors after
powcba = property on which construction begins after
ppisa = property placed in service after
psao/a = portfolio stock acquired on or after
ptybo/a = partnership's taxable year beginning on or after
pyba = plan years beginning after
qiai = qualified investments approved in
qppisi = qualifying property placed in service in
qsbsaa = qualified small business stock acquired after
qwpdt12mpbo = qualified wages paid during the 12-month period beginning on
raeia = research agreements entered into after
rma = rock mined after
rrtbfa = returns required to be filed after
rrtbfea = returns required to be filed electronically after
sia = stock issued after
soea = sales or exchanges after
ta = transfers after
tca = trusts created after
Tca = transactions completed after
tco/a = trusts created on or after
ti = transactions in
tma = transfers made after
toa = transactions occurring after
to/a = transfers on or after
trfa = tax returns filed after
tyba = taxable years beginning after
tyea = taxable years ending after
tyeo/a = taxable years ending on or after
vpisa = vehicles placed in service after
vuicwtba = vessels used in commercial waterway transportation beginning after
wpo/a = wages paid on or after
wptqei = wages paid to qualified employees in
wptqiwbwftea = wages paid to qualified individuals who begin work for the employer after
tyoe = the year of enactment
90da = 90 days after

[Footnotes for JCX-36-14 appear on the following pages]

Footnotes for JCX-36-14:

[1] To the extent the proposals are not fully specified, estimates will be updated as new information becomes available and policy intent is clarified.

[2] Estimate includes the following outlay effects [32]:	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2014-19	2014-24
Reduce the earnings threshold for the refundable portion of the child tax credit to $3,000	---	---	---	---	---	11,703	11,847	11,928	12,050	12,086	12,081	11,703	71,696
EITC modification and simplification ($5,000)	---	---	---	---	---	1,373	1,404	1,431	1,440	1,477	1,509	1,373	8,634
Extend EITC for larger families	---	---	---	---	---	2,192	2,257	2,325	2,381	2,452	2,522	2,192	14,129
American opportunity tax credit	---	---	---	---	---	7,008	6,981	6,955	6,951	6,861	6,841	7,008	41,597
Modify and permanently extend renewable electricity production tax credit	---	---	---	167	309	371	416	414	412	394	408	847	2,892
Expand and simplify the tax credit provided to qualified small employers for non-elective contributions to employee health insurance	7	34	31	24	28	31	34	35	36	39	41	155	340
Restructure assistance to New York City, provide tax incentives for transportation infrastructure	---	200	200	200	200	200	200	200	200	200	200	1,000	2,000
Provide America Fast Forward Bonds and expand eligible uses	---	100	835	2,173	3,646	5,232	6,872	8,547	10,270	12,044	13,870	11,987	63,591
Expand the EITC for workers without qualifying children	---	---	5,089	5,079	5,113	5,109	5,182	5,286	5,346	5,412	5,502	20,390	47,118
Provide for automatic enrollment in IRAs, including a small employer tax credit, and double the tax credit for small employer plan start-up costs	---	---	---	377	393	388	407	436	451	480	511	1,158	3,444
Expand child and dependent care tax credit	---	---	479	531	527	515	506	503	491	493	494	2,052	4,539
Make Pell grants excludable from income and from tax credit calculations	---	---	152	144	136	129	124	119	115	110	106	561	1,134
Increase tobacco taxes and index for inflation [18]	---	-11	-60	-100	-135	-175	-211	-243	-274	-289	-284	-481	-1,781
Provide short-term tax relief to employers and expand FUTA base [18]	471	313	---	---	---	---	---	---	---	---	---	784	784
Modify reporting of tuition expenses and scholarships on Form 1098-T	---	-1	-13	-14	-14	-15	-16	-17	-18	-19	-22	-57	-150
Increase certainty with respect to worker classification	---	35	51	75	89	68	67	67	66	65	65	318	648
Enhance unemployment insurance program integrity [18]	---	-25	-56	-66	-76	-87	-97	-107	-117	-127	-138	-310	-896
Provide the IRS with greater flexibility to address correctable errors	[33]	[33]	-3	-3	-3	-3	-4	-4	-4	-4	-4	-13	-32
Extend paid preparer EITC due diligence requirements to the CTC	---	---	-4	-4	-4	-4	-4	-4	-4	-4	-5	-17	-40
Explicitly provide that the Department of Treasury and IRS have authority to regulate all paid return preparers	[33]	-2	-3	-4	-4	-4	-5	-5	-5	-5	-6	-17	-43
Rationalize tax return filing due dates so they are staggered	---	-1	-4	-7	-9	-12	-14	-16	-18	-20	-21	-33	-123
Simplify the rules for claiming the EITC for workers without qualifying children	---	---	70	71	74	75	77	79	80	81	83	290	690
Total Outlay Effects	478	642	6,764	8,643	10,269	34,094	36,022	37,929	39,849	41,727	43,752	60,890	260,171

[3] Effective with respect to PAB volume cap to be received in, and additional LIHTC allocation authority received for, calendar years beginning after the date of enactment; and effective for projects that are allocated volume cap after the date of enactment.

[4] Effective for elections under section 42(g)(1) that are made after the date of enactment.

[5] Loss of less than $500,000.

[6] Effective for taxable years of a REIT that end after the date of enactment.

[7] The proposed requirements for Long-Term Use Agreements would be effective for Agreements that are either first executed, or subsequently modified, 30 days or more after enactment. The proposed clarification of the general public use requirement would be effective for taxable years ending after the date of enactment.

[8] Effective for sales or assignment of interests in life insurance policies and payments of death benefits in taxable years beginning after December 31, 2014.

[Footnotes for JCX-36-14 continue on the following page]

Footnotes for JCX-36-14 continued:

[9] Effective for contracts issued after December 31, 2014, in taxable years ending after that date.

[10] Gain of less than $500,000.

[11] Estimate includes the following effects:

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2014-19	2014-24
Total Revenue Effects	---	-3	-14	-14	-14	-15	-15	-15	-16	-16	-16	-60	-138
On-budget effects	---	-1	-8	-9	-9	-9	-9	-9	-10	-10	-10	-36	-83
Off-budget effects	---	-3	-5	-5	-6	-6	-6	-6	-6	-6	-6	-25	-55

[12] Estimate includes interaction with item XV.I. (Tax Carried (Profits) Interests as Ordinary Income).

[13] The proposal would be effective for the estates of all decedents dying on or after the effective date, as well as for all estates of decedents dying before the date of enactment as to which the section 6324(a)(1) lien has not expired on the effective date.

[14] Effective for trusts created after the introduction of the bill proposing this change, and to transfers after that date made to pre-existing trusts.

[15] Generally effective for distributions with respect to plan participants or IRA owners who die after December 31, 2014.

[16] Estimate includes the following effects:

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2014-19	2014-24
Total Revenue Effects	---	293	398	407	418	429	440	452	466	479	493	1,945	4,275
On-budget effects	---	287	390	399	409	420	431	443	456	469	483	1,905	4,187
Off-budget effects	---	6	8	8	9	9	9	9	10	10	10	40	88

[17] Estimate includes the following effects:

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2014-19	2014-24
Total Revenue Effects	---	999	1,913	2,178	2,437	2,609	2,712	2,830	2,965	3,095	3,225	10,137	24,964
On-budget effects	---	491	988	1,125	1,269	1,371	1,435	1,501	1,589	1,679	1,765	5,244	13,213
Off-budget effects	---	508	924	1,053	1,169	1,238	1,277	1,329	1,376	1,416	1,460	4,893	11,751

[18] Estimate provided by the Congressional Budget Office.

[19] The revenue estimate assumes a permanent extension of the financing rate at the rate of 10 cents per barrel effective for production after December 31, 2017.

[20] Effective at the applicable rate on such crudes received at a U.S. refinery, entered into the United States, or used or exported as described above after December 31, 2014.

[21] Estimate provided in consultation with the Congressional Budget Office and includes both outlay effects (see footnote 2 above) and indirect effects (following) resulting from the health benefits of a reduction in tobacco consumption:

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2014-19	2014-24
On-budget effects	---	7	20	26	32	40	50	60	73	86	95	126	489
Off-budget effects	---	3	8	11	13	16	20	24	29	35	38	51	197

[22] Effective for employment tax returns required to be filed with respect to wages paid after December 31, 2014.

[23] Estimate includes the following effects:

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2014-19	2014-24
Total Revenue Effects	---	145	493	878	1,038	1,096	1,101	1,089	1,089	1,105	1,127	3,650	9,161
On-budget effects	---	-9	-21	-38	-64	-89	-98	-111	-121	-128	-136	-221	-816
Off-budget effects	---	154	514	916	1102	1186	1199	1200	1210	1234	1263	3,872	9,977

[24] Effective for sales of controlling interests in the stock of applicable C corporations occurring on or after April 10, 2013.

[25] The budgetary savings would not be counted for Congressional scorekeeping purposes.

[26] Effective for a partnership's taxable year ending on or after the date that is two years from the date of enactment.

[27] Negligible revenue effect.

[28] Generally effective for individuals attaining age 70½ after December 31, 2014.

[29] Effective for amounts paid pursuant to bills first rendered more than 90 days after enactment of legislation repealing the tax.

[30] Treasury estimates the proposal would raise $150,000 million.

[31] Treasury estimates the proposal would raise $456,000 million.

[32] The outlay effects are preliminary and subject to change.

[33] Decrease in outlays of less than $500,000.